Custom Private Equity

Elements of a Successful Private Equity Investment

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What are the Elements of a Successful Private Equity Investment?

Element #1:
Proper and Adequate Capitalization

Do you believe that Bill Gates could have created Microsoft® without access to capital?

Do you believe that Warren Buffet would be successful today without proper capitalization?

The overall answer is a resounding **NO**.

Proper capitalization is essential for translating good ideas into great successes. Nothing in investing is more important than access to capital when it is needed. Many strong ideas have failed because there was not enough money for marketing and selling the product or manufacturing the product after the product was sold. Of course, other factors like management and execution play a big part, but <u>without proper capital in the form of cash to pay the bills, no idea can become a winner.</u>

Review of Dun and Bradstreet® data suggest that 80% of small businesses fail within five years of startup. Our experience is that small business fatalities hover yearly above 50%. If a business makes it past five years and is making a profit, then the team must be doing something right.

One of the least risky business investments anyone can make is to provide adequate capital to an experienced management team with a vision and skills to grow a profitable company. Someone who has done it before in a business that you understand. If a company has a good business plan or an innovative idea, and a management team that is experienced in making money, then the only risk is that they will not have enough capital to be successful. We call this the “Buffet” value investing model. Warren Buffet has made his fortune finding good management teams and providing them the tools needed to be successful.

We once consulted with a mulch company. The original investment included pick-up of the raw materials, processing and delivering the finished product to a customer. Simple, clean and profitable. These managers were making money; the investment was paying off handsomely. One of the things that made this program so successful was that the investors gave the managers access to capital to grow the business. The original equipment was running full-time at top speed. The trucks were busy from sun up to sun down. The company was making all the money it could make with the resources it had.

It just so happened that management saw an opportunity to purchase a competitor for a good value and double their production and profitability, virtually overnight. The competitor had a strong asset base that was fairly priced and a knowledgeable team. This was a wonderful strategic move that added much synergism to the existing business.

The purchase was financially out of reach for the current capital structure, more than doubling the company size. The equity investors called us in to consult on the acquisition. As the equity investors involved in the program, it was their responsibility to bring the necessary financial resources to the table and they wanted to know how to execute the acquisition.

WE DO NOT SAY THIS ENOUGH,
IT COSTS MONEY TO BE IN BUSINESS
NEXT TO GREED, INADEQUATE CAPITAL IS
THE GREATEST CAUSE OF FAILURE FOR
PRIVATE COMPANIES & INVESTORS.

After review, we arranged the capital and the company instantly became the market leader in its niche, while more than doubling the investor’s profitability along the way. This was an excellent Private Equity investment and a very wise use of capital.

Being in business in a meaningful way takes money for rent (office payments), telephones, utilities, and general overhead. Marketing takes money and without marketing, few businesses can be successful. Because no one wants to work for free, management must make adequate money to feel they are being paid what they are worth.

I have seen hundreds of stubborn investors who refuse to inject additional capital in a program to get a target company over a hurdle. These were generally poor, nearsighted decisions. If the program was good enough to invest in the first place and it only needs a fraction of the initial investment to achieve success, step up to the plate. **Control Your Fear and Remember The VISION.** Put stipulations on your additional capital, but give, loan, provide the necessary capital, it will save you thousands and make you wealthy.

JUST THINK HOW THE INVESTORS WHO POORLY FUNDED THE FIRST FEW ATTEMPTS AT FEDERAL EXPRESS WOULD HAVE FARED IF THEY HAD PROVIDED ADEQUATE CAPITAL TO FRED SMITH AND ALLOWED HIM TIME TO BUILD THE COMPANY ON THE FIRST ROUND OF FUNDING. THEY MISSED A MULTIBILLION-DOLLAR OPPORTUNITY JUST BECAUSE THEY COULD NOT CONTROL THEIR FEAR.

An interesting story about the psychology surrounding this stubborn streak that many investors harbor. Time and time again, my father and I would argue about how much lease bonus to pay a landowner for a mineral lease. There were over a dozen times during our career working together where we walked away from millions of dollars of oil in the ground, just because he would not pay an additional $5 per acre for a mineral lease. One example was in Howard County, Texas where we were working to purchase leases in 1980. We had an excellent prospect outlined, the primary leases were open for the taking at a price of $60 per acre from the landowner. Everyone else around the prospect had leased their tracts to us for $50/acre. My father refused to budge. It was $10,000 extra for the prime lease in the play. Well, the prospect was finally drilled a few years later, discovering over one-million barrels of oil. We lost that deal over a lousy $10,000. Don’t let your “better judgment” and stubborn streak stand in the way of execution of the original plan.

Knowing how to adequately capitalize a business is a difficult decision. My rule of thumb is to allow the managers, whom I already trust, to tell me how much capital will be necessary, supported by analysis and proper budgeting. Then I further set aside additional resources to assist when the unknown happens.

ELEMENT #2

A Good Marketing Plan executed by a Dynamic Team

When I was in college if anyone ever said to me, "I am a marketing major", I would smile at them and think, you like to party. It was a standing joke that if you liked to party, you needed to be a marketing major. It was not until I owned my first business that I truly understood how valuable a good salesman with a good marketing plan is to any organization.

If you don't admire a good insurance salesman, then you don't understand sales. Anyone who can take that many *"NOs*", often in very rude terms, and still keep pitching deserves all the respect you can give them.

The correct sales plan and the proper team to execute the plan are critical to success. Your sales team will make you or break you.

Confidence in the ability of your team to execute the idea is essential. It takes more than just an idea; it takes a true understanding of how to execute.

The good private equity investor will understand the psychology of the players and what motivates them.

Marketing is not cheap and will gobble up considerable amounts of capital, but for you to be successful, marketing is a requirement.

If your successful sales people are not some of the most highly paid people in your organization, then you need to take a look at your compensation structure, because a good salesman is worth his weight in gold.

Case in point: We have an associate who spent 15 years as the chief salesperson for a smallish insurance company. If you know anything about insurance, it is all about salesmanship.

This associate laid out a plan, hired a team and grew the company from $30 million to a $600 million in assets in just a few years, strictly through salesmanship. He made the owners wealthy beyond their imagination. His reward, an annual yearend bonus of $1000. Needless to say, after 12 years of hard work and that type of abuse, he is no longer with that company. He is off building another similar insurance company for another owner.

There are many ways to execute a marketing strategy. The guerilla approach to marketing is by far the cheapest and is frequently very effective. There have been several excellent books written on this subject.

I will not take time to tell you about marketing strategies. Do realize, however, that it is critical to identify your market and do it early.

ELEMENT #3: The Proper Attitude

One of the easiest mistakes a novice equity investor can make is to worry about what other people in the investment program are making. I am not talking about the commissions paid to regular people for doing their work, but rather who is making money in the execution of the program.

Let me illustrate my point. To be happy, successful people must:

- realize they have the potential to earn what they are worth;
- feel that the life they are leading is equitable;
- know that their voices are being heard; and
- believe that their expertise is being used to its fullest advantage.

Private Equity Investors recognize that if you surround yourself with successful people, generating and managing the programs in which you invest, your investments will make more money than ever imagined.

All the successful equity investors I know have the attitude that "*I don't know everything I need to know about this investment, so I must surround myself with people who do, and I will listen to their experience."*

If you are a real estate investor, your most valuable people should all be making good money because they are making the deals happen. If they are making money, then you are making money.

If your broker is doing his job by bringing you good properties before they go on the market and by making closings go smoothly (a hugely valuable service indeed), he should be handsomely rewarded.

Your banker is making capital available so you can leverage your investment dollar. Hopefully they are making nice fees, which you should not begrudge them.

Your contractors are making money doing exceptional work for you, on-time and under-budget. If they are doing their jobs, they should be well-rewarded.

Not only is it a sound business strategy, it's mandatory. Let people make money on you for services rendered and contacts provided.

We have an associate I'll call Bob who enjoys success in just about everything he touches. We have discussed at length his secret to success.

Bob frequently reminds me, *I surround myself with people who know what they are doing and I provide the capital and some meager management skills*.

He recently uncovered a very under-served sector of the commercial real estate market. Recognizing the opportunity, he researched the situation and uncovered the right management team to lead the efforts.

This team was a struggling group of professionals with a wide range of talents and a burning desire to be independent of the employer/employee relationship. All they needed was capital.

Bob put this team on an equal footing with him and with one another. Each was given the power to do what they were experienced in doing, and Bob's investment was off to a roaring start.

In their first three years, all the projects the management team have completed have returned over 100% annually to the equity partners and investors, including Bob.

Frequently, you will find that to be successful, all a team needs is capital.

ELEMENT #4: Motivation

Motivation must be understood in any Private Equity investment. This goes directly to the number one reason for failure of any investment: GREED.

You want to invest in people who place you on the same level of importance as themselves and their families. Don't invest with someone whose needs come above those of the deal and ahead of your own.

On the other hand, steer clear of the investor who places his money above everything else, to the detriment of the program and the management team.

Avoid the investor who will remove his support or critical capital just because its performance doesn't meet projections for one quarter or one year. An investor who places his returns above all other issues isn't your best partner.

Case in point: A friend of mine in the 1990's became entangled with a so called equity investor who later turned out to be a speculator/promoter in disguise. My friend wanted to build a business around the purchase and sale of oil and gas properties in a very select value niche of the oil and gas business.

He had worked for an oil and gas exploration company for over eight years and executed transactions in this niche on a daily basis under the tutelage of a 40-year veteran of the business. He knew the assets, the competition, and what type of value there was for the taking. He well understood what it would take to run the company, find the acquisitions, and manage the business.

In his search for an equity partner, he came across an individual who called himself an equity investor. Cory was a well-to-do, young man who had inherited a substantial amount of money from a man (his step-father) who he hardly knew.

My friend liked his enthusiasm and took this man into his confidence. My friend showed him the plan and explained how it was to be executed. Cory agreed to front a small amount of money, less than $10,000, and provide his balance sheet to get the company started. In return, he would receive a large ownership position in the company, 51%.

The idea was sound and the business grew at an astounding pace through my friend's efforts, management skills, and vision. Cory brought nothing to the table except the ability to spend money needlessly. This company started out with nothing and in two years was making net cash profits of over $200,000 per month, with virtually no equity investment, only debt.

Regrettably, the price of petroleum declined below any forecast. The company was forced to sell of all the assets, requiring this company to close its door.

What was really poor about the behavior of the so called "investor" was that one Monday, when it was evident that the company was in financial trouble, my friend came into the office to discover it empty. Low and behold, the speculator was gone, furniture, fixtures, most of the profits and available cash.

Even though he had made over 100 times his original investment in two years' time, Cory secretly moved out during the weekend and removed his original equity investment, plus a sizeable amount of profits from the bank. At this point in time, it was obvious that Cory was a speculator, only a partner through the good times. He had no stomach for the "down" side of business, leaving my friend holding the bag.

Cory left my friend with virtually no working capital, not even enough to make payroll. Needless to say, this situation escalated to very ugly very quickly, but my friend, stuck it out and settled all accounts. He was the true private equity investor and certainly not a speculator or promoter.

The actions of Cory caused the entire staff immediate hardship, soon putting 10 employees on the street. If Cory had not taken the available working capital, the company would have survived and been successful once more in short order.

The last we heard of Cory, he was selling real estate in Peru.

In order to be a real benefit to your investments, the investor must see more than monetary gain in the program.

ELEMENT #5: A Workable EXIT(s)

From the very beginning, this is something that every investor needs, a plan exiting the private equity investment with as little brain damage as possible. Whether the exit is ever used is up to you and the other participants, but a workable exit needs to be established up-front.

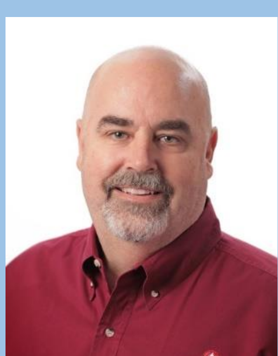
A variety of exit strategies exist, such as: a sale, a liquidation, a competitor buyout, a management buyout, or a public offering and as an astute investor, you must give serious consideration to your exit strategy.

In today's world, the competitor buyout, the management buyout or a public offering are the three preferred ways to exit a private equity investment profitably. The liquidation is usually associated with a failed venture, although it can be a viable exit if planned correctly from the start.

Realize the exit may take as long as a few years as you wait for market cycles to come into favor (commodity prices are a prime example). Knowing when to sell and the patience to wait for the correct time is the key to making money in these markets.

Because each exit is dependent on the markets and supply/demand issues, I will not elaborate further on this topic today, except to say, the simpler the structure and the easier you can make the exit happen, the more profitable the exit will be in time and money.

Thanks for reading.



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