

# Future planning

How private equity funding can help your business **Interviewed by Troy Sympson**

**P**rivate equity funding is a transaction that can provide liquidity and growth capital to an owner who doesn't want to sell the business, but does want to realize some of the benefits of a sale or merger.

"Private equity funding can benefit owners by giving them a significant portion of the value of the business in cash, while maintaining an ownership interest in the recapitalized company going forward," says Bob McDonald, CPA, CM&AA, a principal with Briggs & Veselka Co.

"The transactions are usually conducted with a private equity group that contributes equity to recapitalize the company."

Private equity funding can divide a company's equity into two or more classes, with provisions to serve the objectives of the owners. The owners grow the business, while the financial partner provides assistance on financial, strategic and exit issues. At a later date, usually five to seven years, the company could either be sold to another firm, go public, or undertake another recapitalization.

*Smart Business* spoke with McDonald about private equity funding and how it can offer benefits to all parties involved.

## For whom is private equity funding best suited?

Private equity funding allows owners to achieve personal liquidity without sacrificing the operating control of the company they built. Through a recapitalization, a portion of an owner's equity is sold to the private equity group (either a minority or a majority interest), while maintaining operating and ownership control. This scenario is an alternative to total sale or regulatory scrutiny of a public offering. The owner is able to gain a financial partner to assist with strategic issues without interference in day-to-day operations. With its access to substantial



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financial resources, the financial partner supports the company in expansion plans and/or pursuing strategic acquisitions. By selling a portion of the company, the owner can eliminate personal guarantees on company debt, diversify net worth, and continue to run the company, if they choose. This newfound ability to grow increases the value of the owner's retained equity position. Private equity funding is an excellent option to facilitate the owner's estate planning and execute a succession plan to either the next generation or management.

## What about retaining key employees?

Non Qualified Stock Options (NQSO) are great ways to help retain key employees. Even if a private equity group is not involved, NQSOs should be considered as part of an owner's exit strategy. The goal of a private equity fund is to build value, therefore the investors expect a high rate of return on their acquisition. While they are very experienced in business, the private

equity group does not typically have the operational experience needed to efficiently run the acquired business. For that reason, the investors generally retain the owner and key employees. In contrast, if an owner sold to a competitor, the new buyer may not want to retain these employees.

The company can grant NQSOs only to the employees it chooses. The options are not taxable to the employee until the option is exercised. At the time, the employee recognizes income equal to the fair market value of the vested amount, and the company receives a deduction for the amount. A good tool is to grant NQSO on a vested schedule. If, for example, an employee is to be granted 5 percent of the stock, vesting at 1 percent per year, the employee has an incentive to stay with the company for at least five years.

## Why would I want to give ownership to my key employees?

Assuming the company is successful, it is probably in the 35 percent tax bracket. Since the company receives a deduction for the value of the NQSO, it is saving 35 percent of that value in taxes. The remaining 65 percent should be considered as an investment in the company. By giving ownership in the company, the employees will maximize their efforts to help the company grow and become more profitable; the owner's return on his remaining ownership may far exceed the value of the stock granted. This is a decision that has to be carefully weighed, but can be a very good investment in your own company under the right circumstances. <<

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