ENTREPRENEUR AND FAMILY-OWNED BUSINESS INTERVIEW SERIES

More than Money: the intangibles of a private equity partner

AN INTERVIEW WITH BOB HORNE

PROJECT

This interview is part of a series to help entrepreneurs and family-owned businesses think through the benefits, implications, and consequences of taking outside investment. As part of this project, Bantam CEO Jack Duval is interviewing private equity fund managers, middle-market investment bankers, attorneys, accountants, and consultants who advise privately held firms.

BACKGROUND

Bob Horne is a partner at ZS Fund L.P., a private equity firm located in Manhattan. Bob joined ZS in 1992. Previously, he was a Vice President at Salomon Brothers in their mergers and acquisitions department and at Smith Barney in their corporate finance department. Bob earned his B.A. with honors from Harvard College, where he was captain of the tennis team, and his M.B.A. from Stanford Graduate School of Business.

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Jack Duval: What questions do you think business owners looking to raise outside capital should be asking themselves?

Bob Horne: I think they should be asking themselves why they need the money. Obviously, it could be for personal or family liquidity, for growth, or for deleveraging. And are they looking for more than money? If so, are they looking for a sounding board? Is it somebody to help them with acquisitions? Is it somebody to help them attract management talent? An institutional backer that will make it easier for them to get somebody good to join, who might be leery about joining a family business?

Should they think about borrowing money instead of taking in an equity investor because the cost of funds is lower — or should they not take on the risks with leverage?

They should think about the likely cost of the equity in terms of dilution as well as the constraints on control (their control of the business). What are they willing to live with? Then there's the impact on the day-to-day operations of the business, or on major decisions. And then — Will the funds they take in improve their profitability by enabling them to make acquisitions or otherwise.

Jack: Under the aegis of "Are they looking for more than money?", the first thing you mentioned was the sounding board. That's something that I haven't heard before. Let me ask you an open-ended question — Is that something that's common? Do people take in outside capital just to have a kind of professional sounding board?

Bob: No, I don't think that's true as the only reason. But if they're going to take in outside money, then do they really care what else they're getting besides money?

Jack: So, there's another question. It would seem the answer to that would usually be yes. Is that your experience?

Bob: It's usually yes, but there are some business owners who feel like things are going just fine and they just want to diversify their net worth. They don't want to take an investor that's going to be too intrusive, and they really want the liquidity, but they're not looking for anything else.

Jack: In that case, is that an impediment from the investor's perspective? How does that work?

Bob: I think it's fine with certain investors. There are some investors who want to have a lot of say in what goes on in the company, and there are some investors who are perfectly happy being a passive investor. I think the most classic example is Warren Buffett. He's fine to just give people his money and back the right horses.

Jack: And as far as at ZS Fund, do you guys have a policy, or do you go either way?

Bob: We are on the lighter touch side of the spectrum. We're not really looking for a say in the day-to-day operations. We absolutely want a say in strategic decisions and acquisitions and capital-raising scenarios or liquidity events. So we want a seat at the table.

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Jack: Right.

Bob: But there are other firms that, for example, have operating partners on their staff and they make use of those operating partners once they make an investment by having the operating partner go in — familiarizing him or herself with the business, and then making suggestions.

Jack: I've heard that before. In your experience, is that something that's relatively new, or has that been around for a while?

Bob: It's been around 20, 25, 30 years. It's become more prevalent as our business has gotten more competitive, because firms believe that it's just too hard to make money investing in a company and letting it go the way it's been going. But if you can make some changes that somebody else might not make, then you can have an edge. We invest in companies where the owner or owners get cash, and they keep a big stake in the company. And in general, they want to continue to back themselves, if you will, because they have a big investment in the company, and in most cases, they would prefer that somebody not be too intrusive.

Jack: When you say it's more competitive, do you mean that all business is more competitive because there's a lot more people doing it?

Bob: I'm saying the private equity business is more competitive because there is more money that has flowed into it.

Jack: Okay. Is that just the de-risking technique on the private equity firm's side, or is it more of a kind of pitch for value add?

Bob: It's the latter. It's to improve the value of the company.

Jack: You mentioned that top or talented managers might be leery of joining a family business, and the implication was that they might be more comfortable if there was an institutional partner. Is that something that you see frequently?

Bob: Yes, I think that matters in many instances.

Jack: So what's the scenario? If the CEO wants to bring in a president or…

Bob: Yes. And again, that's not a reason to take in outside money in and of itself. But it can be a benefit of taking in outside money.

Jack: So if you are a family-owned business and you are looking to grow in some way, and you know you need somebody with a perspective that you don't have to achieve that growth, then that would be another reason to potentially take in the outside capital?

Bob: Yes.

Jack: They get the growth capital, plus it might be easier to get a higher level of talent.

Bob: Yes, and once outside investors have been taken, there's also more of a willingness to give equity upside to managers coming in. But business owners can always give equity upside (either through actual equity or phantom equity) to managers coming in.

Jack: In your experience, what are some of the biggest surprises for firms that take in outside capital?

Bob: I would say it shouldn't be a surprise, but some people actually have to answer to somebody. They should know this in advance — but I think that the reality of it is sometimes surprising, and that is particularly the case when there are other family members involved in the business, and they want to take family considerations into account when paying and promoting the other family members. Investors sometimes push back on that.

Jack: Can you give me an example? Like if somebody has a sinecure, wouldn't you know that in advance?

Bob: No — That's easy to deal with. I'm talking about a situation where somebody's child or nephew or niece is in their mid-20s, and the CEO/owner of the business wants to promote that person rapidly, in responsibility and/or compensation — more rapidly than they otherwise would, and the other investors say, "Wait a second, we have to do things on an arm's-length basis here."

Jack: And those kinds of issues that come up — Do you discuss those things ahead of time?

Bob: I would say they don't get discussed enough. I would say that usually if somebody wants to invest in the company, they don't want to put somebody off up front. And the business owner is usually saying that the family member in the business is terrific.

Jack: Right.

Bob: The private equity firm — It's not that they're not being transparent, it's just that it doesn't make sense to have that conversation at that time, because it's all hypothetical, and the investor doesn't even know if there will be an issue. That knowledge only comes over time.

Jack: What about red flags? During your due diligence, what are the three biggest red flags that you tend to see that are deal killers?

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Bob: I would say customer concentration, lack of management depth/key man risk, and things that can cause the company's profitability to change significantly that are out of the company's control. So let's say you're selling your product through another company. We were just looking at a company recently that was selling its products at special event shows that were put on by a different company. The retailer puts on special events on a regular basis, and the retailer brings in a company to partner with them, and that company can sell at these events also.

But if the host retailer, so to speak, isn't doing well or doesn't expand, then it's going to hurt the company that we're looking at.

Jack: Interesting. That's an exogenous kind of risk. In those instances, once you figure that out, is that a deal-killer?

Bob: Yes, if too much of their business is based upon that. If there's too much customer concentration, that's a deal killer. If there's a lack of management depth, that's something we usually live with. But may affect valuation.

We might need to factor in hiring a chief financial officer or chief operating officer. If there is real key man risk, then we price that into the deal, too. We're willing to pay less for that company. For example, if we're meeting with a business owner, and they're boasting about being a workaholic and how hard they work, that may be a negative for us.

Jack: Right. And I guess things like key man insurance, don't do anything for you right?

Bob: It doesn't really protect your equity value that much. It can cushion the blow on a temporary basis, but unless you're buying gobs of it, it won't protect the investment. And it's not just somebody dying, it's somebody losing interest. It's somebody getting sick. It could be a number of things.

Jack: That's a great point. And what about customer concentration? Is there a threshold? Is there a bright line for you guys?

Bob: There's no bright line, but I would say that to the extent you have a customer that represents more than 20 percent of your business, then it starts to affect value. This is because the impact on profits is generally greater than the impact on revenues due to some costs being fixed. If you know somebody has a customer that's 20 percent of their business, and that customer goes away, a third of their profits might go away depending on the type of business.

Jack: Right.

Bob: We've done deals with high customer concentration where we got comfortable enough with it to do the deal, but it significantly impacted value.

Jack: Have you ever talked with a company and just said, "Hey, your concentration is too much. If you get that down, the door is open…"

Bob: Yes.

Jack: Have you ever done a high customer concentration deal?

Bob: Yes, we have done that type of deal. Once somebody has a lot of customer concentration, however, it takes years to unwind it in the good way, by getting other customers. You can unwind it the bad way pretty fast.

Jack: Nobody's going to do that. You're right — You have to grow that denominator. In your experience, what conditions lead to the best working relationships with your portfolio companies?

Bob: It's alignment of incentives, and that's why we always want business owners to keep a significant equity stake in the company. We want transparency pre-transaction in terms of goals and the timing for achieving those goals. If a business owner wants to hold on to the company forever after we invest, that's not a good alignment of incentives because at some point, we're going to want to get liquidity too.

Jack: Right.

Bob: If mutual trust is developed over time, usually through some sort of a personal relationship — mostly because the business owners are transparent with what's going on in the business, and sharing the good and the bad in a timely manner — then it makes things a lot easier because our firm and others like us know that bad stuff happens to companies. Just tell us what it is when it happens. Don't put a spin on it, and we'll deal with it.

If there are enough bad things that happen, that are in management's control, then obviously we're going to want to make some sort of a change. In general, however, we we don't want to make a change, because we usually aren't wrong about whether somebody is a good manager.

Jack: Right.

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Bob: But people make mistakes, and there are exogenous factors that impact the business. We invested in a company that distributes all sorts of products to oil and gas rigs. So we knew it was going to do better or worse based on the price of oil, and, sure enough, the price of oil went down. Their business got worse, but they weren't dumber and they weren't bad managers. So we didn't flinch.

Jack: Right — There's a difference. There's growing period over period, and then there is how much you grew compared to everybody else. It could be that everybody else was down 30% and you're flat, which was heroic.

Bob: Exactly.

Jack: On pre-transaction transparency, you mentioned goals and timing to achieve goals. Did you mean the goals of the owner and the timing of those goals?

Bob: No, the goals for the business — How fast do you expect us to grow, and over what time period? It's with respect to the effort of the business owner. So, for the workaholic, once chips are taken off the table, does he or she envision working like a normal person? And having more of a family life? And with respect to ultimate liquidity, what's the reasonable time frame, recognizing that at the outset of a transaction, one never knows when the optimal time is going to be to sell? You'll know either from a personal or a financial standpoint. You're going to play that by ear.

Jack: You mentioned if the owner wanted to keep her equity after your investment. Is that something that happens? Meaning that you would know it up front, and then if that's the case, how would you cash out?

Bob: That happens sometimes because they've done a deal with us and achieved some diversification of their net worth. A potential scenario is that the company would be sold to another private equity firm, and they would stay on as investors. They'd swap out us for somebody else. And we've done that a lot.

Jack: I would think that's the normal way. And your firm's practice is basically to only invest where the owner is going to keep a big stake?

Bob: Yes. We want the owners to keep a 20%-50% stake in the company.

Jack: I would imagine that keeps the incentives aligned naturally.

Bob: Yep.

Jack: Okay. Now, let's turn it around. In your experience, what diligence do you think these firms need to undertake when considering outside investors?

Bob: I think the most important thing they can do is to speak to several owners — not just one, but several with whom we've done a deal, including some where the deal has not gone well. And find out about the actions taken. Second, they should speak to other owners that we've dealt with to see if we were as advertised. What were the surprises they had in terms of dealing with us?

Jack: And in your experience, do the owners of these firms do that?

Bob: I would say they usually talk to a couple. And if I were them, I would probably try to take the time to talk to four or five. It's very, very important that they speak to people involved in deals that haven't gone well.

Jack: It's interesting that you're not the first person to say that — basically verbatim.

Is there anything that you want to add that you think is important?

Bob: If I owned a business, I would probably want to think not just about taking outside capital, but also about the process by which I do it. Do I hire an intermediary? Do I go out to a broad group of people? Do I just try to talk to a small handful? I would say in most instances that the default should be to talk to a broad group of people, even though as investor I hate that. But you don't know where the interest is going to come from. And then, choosing an advisor is critical.

So they should clearly do their homework and interview at least three. They don't have to make a career out of it, but at least three potential advisors.

Jack: When you say "advisors," I assume you mean investment bankers, correct?

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Bob: Yes — But given that investment bankers are biased to get the deal done and make a fee, there's generally not an alignment of incentives. If there's no deal done, the seller doesn't want to pay much of a fee, but then that incentivizes the investment banker just to try to get a deal done and advise the seller to do a deal, even if it may not be in the seller's best interest. So if the business can hire somebody who is experienced, or has a friend who is experienced in doing deals, they can just be their consiglieri — and they are not getting paid a transaction fee, either because they are a friend or they're just an advisor who you pay by the hour. If I were a business owner, I think that's probably what I would do. Again, it's cumbersome. It adds cost potentially, but at least you know you've got somebody who only has your best interests at heart.

Jack: Right. Are there people that do that on an hourly basis?

Bob: Not many, because more of the money is on the transaction side. But I'm sure they exist.

Jack: Right. And when an investment banker gets paid, they're getting paid out of the owner's proceeds, right?

Bob: Correct. They'll have a retainer, but the retainer is often somewhere between 2% and 10% of what they would ultimately get as a deal if it happens.

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ABOUT BANTAM INC.

Bantam Inc. (www.bant.am) is a private investment office focused on serving entrepreneurs and business families of significant wealth.

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Our clients value our unwavering advocacy on their behalf, our ability to communicate complex ideas simply, our independent analyses, and our highly responsive work ethic.

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