Entrepreneur

The Do's and Don'ts of Private Equity for Entrepreneurs

Here are four things you should do, and four you shouldn't, when it comes to private equity.

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Here's a hard-earned lesson for entrepreneurs who might take funding at any cost just to achieve their dream: The most critical factor in identifying a private equity partner is how well you align with the PE firm. That sounds simple enough, but it's not.

I know from having started three PE-backed companies that getting funded may seem like the goal, but that's short-sighted. The real objective is to use the capital and expertise of the PE firm to grow the company in ways that benefit everyone involved. That means having a PE partner you can live with after the deal is signed.

To break it down in terms every entrepreneur can use, here are some of the important "do's and don'ts" for a successful PE partnership -- all designed to ensure maximum alignment.

The best practices for a successful PE partnership boil down to making sure you're not an outlier in the PE firm's portfolio. Here are four actionable ways to achieve that:

1. Make sure you fit the PE firm's funding and investment strategy.

Your deal size should be in the same range as other companies in the portfolio and your investment timeframe should be typical to theirs. The PE firm's investment timeline is driven by the agreements it has with its investors and each PE firm has a different time horizon. For example, large institutional investors generally require shorter timeframes and family office investors often take a longer view. Partner with a firm that has investors who will stick with you for your optimal investment cycle. The PE partner in one of my previous companies forced a sale just as we were beginning to realize the benefits of scale that would have accelerated our growth. The sale met their investment needs, but we felt shortchanged.

2. Target firms that have interest and experience in your industry.

"Interest is more important because you can help frame the PE firm's passion and they'll dedicate the resources to understand your business and help it grow," says Deb Schwarz, CEO of LAC Group, a Los Angeles-based provider of library and knowledge management services. Having industry experience facilitates due diligence because they know the nuance of your space.

3. Understand the PE firm's decision-making process.

Be very practical and ask for stories about how decisions are made. Interview the CEOs of past and present portfolio companies to verify what you're being told. An early PE funder asked me for three references, including one negative -- so I asked the same of them. All's fair in PE funding.

"It's very important to follow through on these references," adds Schwarz. "The people we called were founders or CEOs of companies recently acquired by the PE firm we were considering an investment from; the calls were enlightening and reassured us we were making a smart choice."

4. Find out how the partner responsible for your investment gets paid.

The key question: "Do you make money if I make money?" Ideally, you want a PE partner who has personal skin in the game so your wealth generation goals are aligned.

The "don'ts" of PE funding are about navigating the process without naiveté. Here are four traps to avoid:

1. Don't go "exclusive" too soon.

Remember, the PE firms need you, too. They have investor money to grow and are looking for proven leaders with solid business models. Understand as much as you can about the details of the paperwork

before you sign an exclusive arrangement that takes you out of negotiations with other firms. With every deal, the devil is in the details, and you won't see that until you review the transaction agreements.

2. Don't be afraid of "thorough" money -- and beware fast money.

"Don't be afraid of someone being thorough with you," says Eli Boufis, managing director of Driehaus Private Equity, LLC. "Things don't always work out as planned and the PE firm that does its homework is better equipped to navigate, rather than berate, its way through the storm." (Note: DPE is an investor in my current company, Energy Distribution Partners.)

3. Don't cheap out on your advisors.

In particular, hire an experienced transaction lawyer. Lawyers can save you time and anxiety because they know what's standard in PE deals, meaning they can set realistic expectations for you. They also know when the PE firm is offering something good or rare in a deal -- another sign of alignment with the right partner.

4. Don't be defensive when the PE firm offers operating expertise.

Most entrepreneurs read this as interference, but for me, it's a valuable advisory resource. With a good PE partner you have access to directors who add to your strategic brain trust, shared services, including human resources, and credible introductions to other investors and better banking relationships.

The two keys to a successful PE relationship are to make sure you fit the firm's investment profile and knowing how to navigate the funding process. Doing these things right will provide the kind of alignment you need for a partnership -- one that can withstand the challenges that inevitably visit every entrepreneurial venture.

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