

# AUSTIN BUSINESS JOURNAL

## IN DEPTH: COMMERCIAL REAL ESTATE REPORT AND BANKING & FINANCE

From the January 9, 2004 print edition

### Grow with private equity partners

**Gary Valdez**  
Special to the Austin Business Journal

Traditional industries in Central Texas, such as manufacturing, distribution, financial and retail, have watched the technology sector finance its growth using private equity partners rather than debt over the past eight years.

Furthermore, privately held companies historically have relied upon banks to provide senior debt for growth opportunities, but the conservative nature of such methods and the capital constraints of personal guarantee requirements have made rapid growth for these companies difficult as well.

As a result, there is significant need for private debt and equity in the marketplace. And with the recent improvement of the economy, management teams in traditional industries and within privately held companies can decide between using bank debt versus private equity or private debt to grow their businesses.

It boils down to one key question for these businesses: Does management prefer to retain full control of the company and take a slower route to growth and value generation, or would it rather find a private equity partner whose capital and resources can increase the rate of growth and value of the company in a shorter period of time?

Private debt and equity financing can be grouped into three general categories: venture capital, middle-market private equity and mezzanine debt.

Venture capital typically is targeted at early-stage companies that have a scalable business model centered on a key piece of intellectual property. As a result, venture capital traditionally has delivered high risk but also high returns.

On the other hand, middle-market private equity and mezzanine debt usually focus on more traditional businesses that involve lower levels of risk. The purpose of middle-market private equity and debt is to provide traditional companies with resources and capital beyond what senior bank financing can provide for growth.

Good candidates for this type of financing have the following characteristics:

- revenue is greater than \$10 million;
- earnings before interest, taxes, depreciation and amortization are greater than 15 percent;

- company has been in business for at least three years;
- strong management teams have significant ownership interest; and
- company has a presence in compelling markets.

The idea is to use the private investor's expertise and capital to allow the company to grow to the next level. As the company successfully grows into a larger entity, it becomes a more likely candidate for a liquidity event such as an acquisition, initial public offering or distribution of significant dividends to shareholders.

Mezzanine debt -- also known as subordinated debt -- typically has two components: an above-prime interest rate that is paid annually and options that can be converted into ownership in the company at the time of a liquidity event.

Middle-market private equity financing typically is structured as preferred stock rather than common stock so that the investors get paid first during a liquidity event. The investment normally carries a dividend that is accrued over the investment period. The preferred equity investors also may require a board position.

Searching for the right private equity investor is not as daunting as you may think. Looking up institutional private equity investors' Web sites provides good descriptions of the investment focus for each fund. The Small Business Administration Web site also has a current listing of small business investment corporations by geographic region with current contact information.

But the best opportunity to obtain the attention of a private equity investor is a referral from a qualified investment bank, merchant bank, commercial bank, law firm or accounting firm. Having a professional reference will add credibility to your company.

Before approaching an investor, your company should develop a written business plan and projected financial statements for the management team to follow and implement.

Not only are the capital requirements important, but the intangible qualities of a private equity partner are critical. Finding the right institutional investor with industry knowledge, experience and contacts is key. When a partner provides money as well as a strategic benefit to the company, rapid growth and higher company valuation can be achieved in a shorter time.

Private debt and equity financing can be used to grow into new markets or finance working capital needs. And as the public stock markets improve, management teams who can grow rapidly have strong opportunities for an acquisition or IPO.

*GARY VALDEZ is president of Austin-based Focus Strategies LLC, an investment firm. He can be reached at (gvaldez@focus-strategies.com).*

© 2004 American City Business Journals Inc.

[Web reprint information](#) All contents of this site © American City Business Journals Inc. All rights reserved.