

Strategic Capital: Making the Most of Minority Investment



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SD Capital

As value growth and M&A advisors, we frequently see situations where a minority investor can add immediate value to an existing business. Although potentially dilutive to current ownership, a minority investor often provides the growth capital, industry knowledge, contacts, and management experience necessary to position a company for maximum value upon exit.

However, bringing on a minority investor is not without risk. Alignment of vision is key, as is understanding the ground rules for decision-making post-investment. The following topics are key in evaluating whether a minority investor is right for your business.

Strategic Plan: Defining the Purpose of Capital Infusion / Minority Recapitalization

At the heart of any successful minority investment lies a clear and compelling strategic or business plan outlining the purpose and utilization of the funds sought. This plan serves as a roadmap, guiding prospective minority investors through the company's vision, goals/objectives, and growth trajectory while articulating how the funds will be deployed to drive value creation. Whether it is expanding into new markets, scaling operations, investing in research and development, or pursuing strategic acquisitions, the plan should delineate the company's overarching strategy and the role that capital plays in achieving these objectives. The plan should be supported by financial projections that define the amount of funds being sought, the timing of infusion, and whether additional monies will be needed for the business. Investors must also understand how and over what time horizon their investment will be realized. Thus, what is the plan for repayment (exit or buyout)?

The nature of the capital to be raised can significantly impact the business, affecting everything from day-to-day management/control of decision making, distributions, exit timing, etc. Minority investment, most often provided by private equity, can take multiple forms – direct equity investment, or often, a preferred instrument. Such investors typically seek to compel a downstream sale (drag-along rights) and often desire a degree of control via board participation and positive/negative control provisions.

Holding periods for private equity investors will often be in the 3–5-year range. Downside protection in the form of a sale preference is typically required. Participating in preferred stock or straight equity investment with downside protection is an example of a vehicle. High-net-worth individuals may also be an option; however, relative sophistication will vary, as will the creation of upside value via the relationships brought to the table. While beyond the scope of this article, it is important to note that the form of organization (S Corp, etc.) will potentially impact the form of equity investment (investors may seek a change in the company's organizational structure).

Further, for some regulated industries such as government contractors, companies must be cognizant of how the equity investor could negatively impact status as a small business, etc., due to the SBA affiliation rules.

Build Relationships in Advance

For middle-market businesses, proactive preparation means taking strategic steps well in advance of needing capital. Firstly, developing relationships with potential investors early on fosters trust and familiarity, making the eventual fundraising process smoother and more likely to yield favorable outcomes. Building relationships in advance involves actively engaging with potential investors, industry peers, and advisors before the need for capital arises. This proactive approach goes beyond mere networking; it entails fostering genuine connections. These pre-existing relationships can lay the groundwork for a successful outcome.

Maintain Meticulous Financials and Investor Grade Artifacts

As part of the process, investors will perform due diligence on the company in advance of investment. Preparing and maintaining a data room of key artifacts is vital to ensuring a smooth pathway to close. Standard data room material includes organizational documents, employee information, customer information, and financial data. Presenting a comprehensive and transparent financial picture to potential investors entails ensuring financial

statements adhere to Generally Accepted Accounting Principles (GAAP) and possibly also gaining additional assurances, such as audits or quality of earnings reports. GAAP-compliant financial statements provide a standardized framework for recording and reporting financial transactions, ensuring consistency, comparability, and accuracy.

Responsiveness: Being Easy to Work With

In the fast-paced world of growth capital, responsiveness is key to fostering positive relationships with potential investors. Being easy to work with entails promptly addressing requests for information and providing thorough answers to questions. Whether it is providing financial statements, market research, or due diligence materials, companies should strive to deliver requested information in a timely manner, respecting investors' time and urgency. This proactive approach expedites the due diligence process and instills confidence in investors, signaling the company's readiness and reliability. By prioritizing timeliness, thoroughness, and collaboration in their interactions with investors, companies can enhance their reputation, streamline the capital-raising process, and ultimately lay the foundation for productive and mutually beneficial partnerships.

Building a Strong Deal Team

Building a strong deal team for a transaction is vital and is no different than if the Company were seeking a sale of the entire business. Having a strong deal/M&A attorney, knowledgeable tax advisor, and deal advisor (Investment Bank) is critical to success. In those situations where the investor is permitting the owners to take some "chips off the table," a wealth advisor should be part of the team. Understanding the underlying economics, control provisions, and downstream expectations of any investor is paramount to not ceding control of the business to others. Further, running a process on top of one's day job can be daunting for an owner or member of the C-Suite. Having an experienced advisor quarterback the process, will pay for itself many times over.

Raising capital through minority investment is often needed to fund growth and build value in a business. The nature of the investment can significantly impact how a company is run and managed post-investment. This article highlighted some of the considerations and guidelines that should be considered prior to beginning a process and to help ensure a successful outcome.

About SD Capital

SD Capital is a premier, full-service, value advisory and investment banking practice that assists middle-market companies in creating and maximizing business value. We provide strategic evaluation and execution of various downstream sales and monetization pathways. With decades of combined executive experience running, owning and advising private companies our team is uniquely positioned to guide owners through the complex process of growing and selling their companies.

Learn more at www.sdcapital.com or contact the team directly at contact@sdcapital.com.

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