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ENSight

PE firms will soon be looking to invest: is your business ready?

Should you be considering a private equity investor?

Amid a sluggish global economy left in the wake of COVID-19, mergers and acquisitions (M&A) may be an important catalyst to help kick-start the economy and may provide much needed growth and expansion across the global (and, most importantly, local) economy.

Significant amounts of cash on hand (or what is colloquially known as "dry-powder") means that PE firms could soon be actively seeking to acquire distressed assets or non-core businesses that are being disposed of by large companies following a strategic asset shedding in a post COVID-19 world. Given current low trading prices, we may also see take-private transaction activity where public companies are the target.

If you are thinking of selling to a PE firm, it is important that you find the right partner. Different types of PE firms invest in different types of businesses at varying stages of development and life cycles. Some PE firms acquire start-up businesses while others acquire businesses that are in growth or expansion phase. Some specialist PE firms also focus on providing "private debt" to companies that are in financial difficulty.

What are the private equity firms looking for?

Mid-sized companies (such as family businesses and companies with annual gross revenue of between ZAR50-million and ZAR1-billion) are a favourite target amongst PE firms because the return on investment in these companies can be significant.

Depending on the PE firm's investment strategy, it may look to acquire a significant minority interest (anywhere between 20% and 40%), a majority-controlling interest on the basis that key management remain with some "skin-in-the-game", or the entire business.

Most times the PE firm will become involved in supporting the business by appointing one or more directors to the board to assist management in developing and executing a business strategy.

PE firms pick targets that have the potential to grow and can be sold at a profit so as to provide returns to its investors. Most PE firms have a seven to 10-year investment horizon. Divestments generally occur through disposal of equity or other interests in the business or a listing.

What could you gain by bringing in a PE firm as an equity partner?

Some of the key benefits of an investment by a PE firm include:

- A long term injection of capital.
- Support for operational and financial matters.
- Developing a long-term investment and divestment strategy.

PE firms also leverage their portfolio companies to provide networks to assist with key business priorities, such as accessing additional markets and introductions to other strategic partners.

Why could your company be an attractive target to a PE firm?

Middle market M&A can be a major force for accelerating growth in South Africa. Given the geographic diversity of some of the mid-sized companies operating in South Africa and the spectrum of sectors within which they operate, such as logistics, energy, property, fintech, healthcare, education, food, hospitality and financial services, these mid-sized companies present significant investment opportunities for PE firms.

PE firms will be on the lookout for businesses that are well positioned in the market in which they operate, have a defensible business model, a strong management team and are able to generate good cash flows over the medium to long term, as we slowly embark on the road to economic recovery.

Astute PE firms operating in the South African market are going to be waiting and ready to deploy cash to acquire well-priced, mid-sized companies as and when these acquisition opportunities present themselves as was recently announced by a major South African PE firm that it has raised ZAR5-billion to invest in mid-sized South African companies that have been hit by the economic impact of COVID-19, which new fund will seek out businesses with enterprise values of between ZAR250-million and ZAR4-billion.

Is your business deal ready?

Whatever your motives are, be it to monetise all or a part of your business, part of a succession plan or to access capital, now may be the time to consider a PE firm as a strategic investor. However, before you do, you need to be deal ready. As with most things, preparation is key. By becoming deal-ready you can avoid some of the obstacles and challenges that could impede the success of both deal execution and implementation.

Although the preference is (and the aim should always be) a simple deal, in reality, the M&A transaction process is not simple and often involves a lengthy due diligence investigation and complicated transaction documentation. A PE deal brings its own nuances such as complex tax, financing and other legal structuring.

If you are deal ready and have leveraged outside expertise (such as M&A legal counsel) you can then make informed M&A decisions that are likely to result in a successful and balanced deal with fewer setbacks along the way.

What does the M&A process involve?

Typically, an M&A transaction can be divided into the following five-step process:

- **Step 1**: early stage negotiations
- **Step 2**: sign offer letter / non-binding term sheet
- **Step 3**: buyer starts extensive due diligence (covering legal, tax, financial, operations areas)
- **Step 4**: negotiate, draft and execute transaction agreements and apply for regulatory approvals
- **Step 5**: implementation

Most mid-sized companies tend to rely on management to run the M&A process. However, the nuances and technicalities of an M&A transaction require a certain level of expertise and resources. This knowledge should be taken advantage of as opposed to primarily relying on management who may not have the time or technical expertise to successfully execute M&A transactions.

Bringing in your external legal counsel at an early stage will help you prepare for and navigate the five-step M&A process by assisting with preparation or vetting of non-binding term sheets, confidentiality agreements, due diligence questionnaires, sale agreements, shareholder agreements and dealing with regulatory issues.

How do you become deal ready?

Start by first putting together a "teaser". A teaser provides a broad overview of the nature of the business and a financial profile that gives the PE firm just enough information that will get them coming back for more.

Get your financial information in order. The lack of reliable financial data will make the financial due diligence difficult to complete and you could be putting yourself at a disadvantage when it comes to valuation.

Understand the value of your business and be ready to explain the impact of the various economic and socio-economic factors that may have recently impacted the value of the business. You must be able to justify why these short-term factors will not impact the long-term value of the business.

Make sure you have all key material contracts and other legal documentation that underpin the business readily available – you will need to make these available as part of the legal due diligence and you will need to understand the consequences of a change of control.

Bring your external legal counsel, bankers, tax advisors and, if required, corporate advisor on board as soon as possible because harnessing this external expertise will ensure that the deal process runs smoothly.

What's next?

Successful M&A deals require careful planning and patience because it can take anywhere between four and eight months to complete, particularly if regulatory approvals are required to be obtained before the deal can be implemented.

Developing or getting help with valuation, tax, legal and financial matters in advance of seeking a strategic investor, or to make sure that you are not unprepared when a PE firm comes unexpectedly knocking, will ensure that you are ready when an opportunity presents itself.

Do not delay in speaking to your legal counsel and corporate advisor if you are considering doing, or are approached to undertake a M&A transaction. Bringing in the experts early will facilitate the planning and execution of a smooth deal.

If you are considering an M&A transaction or are approached to do an M&A transaction, it is imperative that advice is sought sooner rather than later. Please speak to your usual ENSafrica contact or contact the partner listed below.

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