Sales and Acquisitions in the Middle Market:

Partnering Between Entrepreneurs and Private Investors

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Table of Contents

I. Introduction
II. Launching and Growing the Business
  a. The Entrepreneur's Perspective
  b. The Venture Capital Investor's Perspective
III. Selling the Business to a Private Equity Investor
  a. The Private Equity Investor's Perspective
  b. Transaction Structures
  c. Management Compensation
  d. Working Together to Grow the Company
IV. Exiting the Investment
  a. The Investment Banker and Lawyer
  b. The Sale Process
  c. The Strategic Buyer's Perspective
V. Conclusion

I. Introduction

The boom in entrepreneurship, venture capital, private equity investment, and merger and acquisition ("M&A") activity in the middle market[1] over the past decade has generated great interest from professionals, and aspiring professionals, across the economy. This article outlines for existing or prospective entrepreneurs, venture capital investors and private equity investors a roadmap of best practices, activities and considerations for working together to launch and grow companies that will reach their fullest potential in their industries. We write with the deep and longstanding belief, based on decades of experience, that entrepreneurship and growth through the deployment of capital and management expertise of private investors brings innovation that is good for industries and the people who work in those industries, throughout the country and the world.

II. Launching and Growing the Business

a. The Entrepreneur's Perspective

Prior to launching an entrepreneurial venture, the entrepreneur should conduct research to understand the landscape of products and legal service providers that are already in existence in the industry that is targeted, and the trends affecting those providers. Experience has shown that successful entrepreneurs generally work in the industry for some time before "striking out on their own" with a start up in a sector related to that in which the entrepreneur has worked. The experience and background of the entrepreneur are usually important factors for customers making purchasing decisions in the industry; customers tend to focus on track record, credibility, thought leadership, and industry leadership when

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[1] We define the middle market as including companies with anywhere from $5 million to $1 billion of annual revenues. *See* JOHN LANIER, VALUE-CREATION IN MIDDLE MARKET PRIVATE EQUITY 7 (2015).

evaluating providers of products and services. It is usually important that the new company provides a product or service that solves a real problem for customers and will therefore be regarded as valuable, is differentiated from other providers in the market, and is focused on a narrow segment of the market that permits capture of market share in the critical, early years of the venture.

When a new product or services company is launched, there are several major components that must be addressed, including: (1) product or service identification, design and development; (2) management team recruitment and oversight; (3) financial support and monitoring; (4) operations establishment and management; (5) sales and marketing; and (6) human resources. From a legal perspective, the new company is typically organized as either a C-corporation or as a limited liability company ("LLC"). By organizing a new entity, the founders limit personal liability to the owners of the entity for the obligations, liabilities, debts or losses of the company. If an LLC is the chosen form, an LLC agreement will set forth, among other items, establishment of the company's officers; capital contributions by members of the LLC; allocation of profits and losses to the members; delivery of a Certificate of Formation to the Secretary of State of the state in which the company will be organized; and establishment of a registered agent in that state.[2]

Growth should be managed at a pace that matches the organization's capacity, not a rush to finish line. Absolutely, product or service quality and customer satisfaction must be maintained as the company grows. Research and development and product management must be prioritized, and the sales team must be disciplined as it grows, perhaps into a territorial structure across the U.S. Unnecessary risks should be avoided. For example, current products or services should not be offered to new clients unless the management team is confident that they can

[2] *See* Heather Huston, *What is an LLC and How to Form an LLC*, WOLTERS KLUWER (Sept. 27, 2022), https://www.wolterskluwer.com/en/expert-insights/how-to-form-an-llc-what-is-an-llc-advantages-disadvantages-and-more.

be delivered successfully; new products or services should not be developed unless they are synergistic with current products or services in terms of sales process, delivery process, etc., and new products or services should not be developed unless they are value-added, cost-effective additions to current products or services.

Ultimately, culture and values are the most important aspect of a new venture. Customers want companies with great products and are also customer focused and committed to high levels of service, and who understand and care about their requirements. If the provider is there for its customers, the customers will be there for the provider in the future, and they will reward the provider for being there by purchasing more of the provider's products or services. Employees want to work for companies that have integrity and are focused on true value creation for the long run, which provides security and rewards for them and their families.

b. The Venture Capital Investor's Perspective

Entrepreneurs who intend to sell their company to a private equity investor will raise capital from a venture capital or angel investor years earlier to obtain capital and operational expertise for growth. Venture capital investors focus on startup and early stage-businesses, while private equity investors focus on established, profitable companies with continued growth prospects. The factors described below for an entrepreneur to evaluate a private equity investor apply equally well to evaluating a venture capital investor. There are many issues that surround the entrepreneur's entering into an agreement with a venture capital investor, including:

(1) What percentage of the company will be sold to the investor, and at what valuation?

(2) What board rights will the investor have?

(3) What is the process for the investor to participate in the deployment of capital and the achievement of growth and operational efficiencies?

III. Selling the Business to a Private Equity Investor

Entrepreneurs seeking to sell their companies to private equity investors should evaluate the investors from a variety of perspectives, including the ready availability of the necessary capital, the experience and personalities of the management team at the firm, and the desired time horizon of the firm's investment. It is of paramount importance that the entrepreneur can develop a rapport and relationships of trust and partnership with the investor; this will ensure that the entrepreneur and investment firm can work through challenging times in a partnership and collaborative manner. The entrepreneur and investment firm will likely be financial partners as well; in most situations, the entrepreneur will "roll" a portion of their equity (often in the 15%-25% range) in the hope of receiving a "second bite at the apple" upon the investment firm's exit in 3-5 years.

a. The Perspective of the Private Equity Investor

Private equity investors are generally focused on investing in portfolio companies with which they can partner to create true value, which will yield a return on their investment of at least 2 times in 3-5 years, to use a popular phrase. While some private equity investors will take minority positions in portfolio companies, most will require control positions; while some private equity investors will bring in trusted executives to take over management of the portfolio companies, others prefer for management to remain in place during the investor's hold period. We will discuss the perspective of the private equity investors assuming a control position and that existing management remains in place.

Private equity investors will typically have an "investment thesis," or objective, for their investment in a portfolio company. In evaluating whether to invest in a portfolio company, private equity investors will focus on a variety of factors, including:

(1) a large total addressable market ("TAM");

(2) attractive industry dynamics;

(3) a strong business model;

(4) a compelling value proposition;

(5) mission critical solutions;

(6) sticky clients and partners;

(7) ramping growth;

(8) market leadership;

(9) under-writable scalability and growth plan; and

(10) specialized expertise.[3]

The investor will want to know what problems the portfolio company is solving, and what opportunities exist that have not been fully explained. For example, is the TAM large enough for the company to be scaled? Will there be buyers for the scaled company in 3-5 years?

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[3] *See* LANIER, *supra* note 1, at 86-88; *SS&C Technologies (NASDAQ:SSNC)*, MORNINGSTAR'S MGMT. BEHIND THE MOAT CONFERENCE (Sept. 29, 2020), 4, 8, 10, 14, http://q4live.s22.clientfiles.s3-website-us-east-1.amazonaws.com/211474323/files/doc_presentations/2020/09/Investor-Slides_August-2020_vQ2-2020-update_Morningstar_update_2.pdf; *Marketing: The Increasingly Critical Growth Driver*, TREFOIL GRP., https://trefoilgroup.com/private-equity-firms/ (last visited Dec. 8, 2022).

To achieve the necessary return for the private equity investors, management may look beyond organic growth, when acquisitions can provide another way to grow the revenues and profitability of the portfolio company. The importance of having and implementing a sound strategy for the portfolio company to have ”tuck-in” acquisitions cannot be overstated.

While the financial aspects of the portfolio company are crucial to whether an investment will even be considered, once those financial aspects are confirmed to be promising, the culture of the company and the human capital become key areas of focus. Private equity investors want to invest in portfolio companies where there is a cultural orientation and drive for growth, and the management team wants a partner to help achieve that growth. The private equity investor brings not only the dedicated capital to help achieve the growth, e.g., through acquisitions, but also the financial and operational expertise to support management in achieving the growth.[4]

Of course, private equity investors are focused on the sources of financing for the purchase of their portfolio companies. A good rule of thumb is that a portfolio company that is purchased will be purchased with about 50% equity and 50% debt, although these percentages can vary. The equity can be dedicated from the investor’s own funds, a fund that the private equity investor has raised, or a network of investors that support the private equity investor’s deals. The debt can be procured from a commercial bank or a growing range of sources as explained below, with the private equity investor striving to create the most efficient capital structure based on historical and forecasted performance. It is critical the private equity firm not over-burden the balance sheet with too much debt so the management team can focus on operating results versus

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[4] It is often desirable when a private equity firm purchases a portfolio company for the capital table to be “cleaned up,” which refers to the goal of buying out equity holders who are not contributing or connected to the growth of the company, where that is possible under the terms of the portfolio company’s operating agreement.

liquidity. Typically, the lender will permit the company's debt to reach 4-6 times its annual EBITDA (earnings before interest, taxes, depreciation and amortization) but this will depend on many factors including the recurring and diversified nature of the revenue. The debt can be used for a variety of purposes, such as: acquisition financing; business expansion; debt replacement; equipment purchase; plant expansion; restructuring; and share buybacks.

There is a wide variety of debt available for private equity investors purchasing portfolio companies, such as:

(1) asset based loans;

(2) bond financings;

(3) cash flow loans;

(4) equipment financing;

(5) inventory financing;

(6) letters of credit; and

(7) mezzanine financing.[5]

Most private equity investors have policies, procedures and protocols that they follow when working with portfolio companies. However, and it can be surprising for management teams to learn this, many private equity investors, even large ones, manage portfolio companies without much in the way of documented policies, procedures and protocols for facilitating operational improvements, recruiting new management team

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[5] *See* Brent Arteaga-Biggs, *Private Equity Funding VS Venture Capital Funding VS Debt Funding*, LINKEDIN (Oct. 4, 2021), https://www.linkedin.com/pulse/private-equity-funding-vs-venture-capital-debt-brent-arteaga-biggs?trk=articles_directory; *New Funding Based on Sound Analysis, Not Guesswork*, FISHER ENTER. LLC, https://fisherenterprisesllc.com/acquisition-financing/ https://www.pionline.com/alternatives/private-credit-investors-turn-asset-backed-loans (last visited Dec. 8, 2022).

members, and other activities in working with portfolio companies. They rely on judgment and experience gained from working with companies within a single industry and across multiple industries more than documented procedures. Typically, private equity investors rely on their own networks within the targeted industries, and the networks of operating advisors to the investment firms to generate deal flow.

b. Transaction Structures

There are different transaction structures that could be utilized for the sale of a business to a private equity investor, including a stock purchase, asset purchase or merger. Under an asset purchase and sale, the private equity investor purchases the assets of the business, including equipment, contractual rights (such as customer orders, license agreements, and leases), intellectual property, business records, licenses and goodwill. The seller may retain certain liabilities of the company, such as litigation claim related liabilities or liabilities to employees or former employees incurred before closing. Excluded assets from the purchase agreement will often include cash and litigation claims.[6]

An alternative to the asset purchase and sale structure is the stock sale or merger structure. Here, the private equity investor acquires the equity interests in the business, such as the capital stock in a corporation or the memberships interests in a limited liability company, which provides the buyer with all the assets as well as liabilities of the company.[7]

Regardless whether an asset purchase and sale structure or stock sale or merger structure is utilized, the agreement will specify the purchase price, which will include an amount to be paid on closing and also can include an earnout, which is an amount to be paid in the future if

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[6] *See* Erik Lopez, *Anatomy of an Asset Purchase Agreement*, THE M&A LAWYER BLOG, https://themalawyer.com/anatomy-of-an-asset-purchase-agreement/ (last visited Dec. 8, 2022).

[7] *See* KENNETH MARKS, ET AL., MIDDLE MARKET M&A: HANDBOOK FOR INVESTMENT BANKING AND BUSINESS CONSULTING 316-17 (2d ed. 2022).

the company achieves predetermined targets. The agreement will also include representations and warranties from the seller as well as the purchaser. The agreement may also include non-competition and non-solicitation restrictions on the seller.

c. Management Compensation

To achieve growth, it is critical for the private equity investor to provide the management team with incentive compensation so that, upon exit for the investor, the management team can also share in the value that was created during the hold period.[8] While there are a variety of mechanisms to provide management with incentive compensation, including the grant of equity interests, in most situations the company will grant profits interests or stock options to management team members.

Profits interests are structured such that, at the time of exercise of the interests, the purchase price of the equity interests as to which the profits interests are exercised are paid to the company. Typically, a portion of the profits interest will vest based on the time of continued employment (e.g., 25% vesting each year for 4 years); and a portion of the profits interest will vest based on performance of the company (e.g., based on the investor's achievement of a minimum internal rate of return, or a minimum multiple of invested capital). There are many possible permutations of the vesting approach described above, e.g., if the investor achieves a higher IRR or MOIC than the minimum, then more of the profits will vest along a prorated scale. For management team members with operational responsibilities that are quantifiable, a portion of the profits interest may vest based on achievement of defined goals, e.g., for a sales professional, this portion may vest based on achievement of revenue generation targets and/or EBITDA margin. Generally, if a private equity investor exits the investment before the typical 5-year hold

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[8] *See* Wendi Lazar & Katherine Blostein, *Understanding Executive Arrangements in Private Equity*, REUTERS (July 14, 2021), https://www.reuters.com/legal/legalindustry/understanding-executive-arrangements-private-equity-2021-07-14/.

period, the vesting of profits interests to the management team may be accolated. Management team members need to understand that, in most situations, as consideration for receiving profits interests, they will be required to agree to a restrictive covenant agreement, confidentiality agreement and non-competition/non-solicitation agreement.

From a tax perspective, the award of profits interests is intended to fall within the meaning of Revenue Procedure 93-27 as of the data of issuance. The management team members receiving profits interests may be asked to make an election under Section 83(b) of the Internal Revenue Code of 1986 and Treasury Regulation section 1.83-2 et seq. to the effect that, if there is any taxable income associated with the grant of the profits interest, it will constitute taxable income for the calendar year in which they were granted. In almost all situations, management team members will pay taxes on the payments made under profits interest agreements when the payments are made rather than making payments.

The award of profits interests aligns the goals of individual management team members with those of the private equity investor. For example, the equity value of the company can be increased through debt paydown (i.e., a dollar of debt repaid increases the equity value of the company by a dollar), EBITDA growth (i.e., a dollar of increased earnings increases the equity value of the company by a multiple of that dollar), and/or valuation multiple expansion (i.e., the multiple upon exit is higher than the multiple paid by the private equity investor at the start of the hold period).

It is important that the private equity investor make a priority of explaining the profits interest agreement, and how it will function based on a range of potential financial results of the company, at the outset of the investment. Profits interests agreements and their calculation are complicated, and the stakes are high from a personal financial perspective for management team members.

d. Working Together to Grow the Company

It is imperative that the private equity investor and the management team work together to grow the company. When challenges arise, the culture of cooperation and personalities of the investor team and management team can become factors. For example, what if the CEO and investor do not agree on whether an acquisition makes sense at the price required to close the purchase? What if management team members want to exit sooner because they want liquidity for themselves and their families, while the investor wants to exit later for reasons that might be unrelated to the business performance of the company, such as the availability of capital gains tax treatment for the investor's gains or the performance of other companies in the investor's fund? The importance of focusing on the alignment of values, purposes and visions between the private equity investor and the management team cannot be overstated.[9]

IV. Exiting the Investment

a. The Investment Banker and Lawyer

The investment banker plays a critical role in the sale of a company. The banker will, among other things:

(1) evaluate the company and determine the appropriate valuation using different potential methodologies;

(2) develop financial modeling to justify the valuation along with the business plan and pro forma financial adjustments;

(3) research the industry for available strategic buyers;

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[9] LANIER, *supra* note 1, at 277-79.

(4) identify private equity investors that have platform companies in the industry or interest in acquiring a company as a platform company;

(5) ensure that, particularly with companies that have achieved $10 million or more+ TTM (trailing twelve month) EBITDA, the seller proactively conduct a quality of earnings and market study deliverables prior to launching a sale process in an effort to truncate the due diligence process;

(6) work with management to compile the required information for the Confidential Information Memorandum ("CIM") and develop the CIM, which often requires addressing proactively issues that buyers will raise to justify a lower valuation (e.g., concerns with the EBITDA margin);

(7) disseminate the CIMs and identify the serious bidders willing to provide non-binding Indications of Interest ("IOIs");

(8) lead negotiations with the potential buyers and help determine the buyer with whom a letter of intent ("LOI") and confidentiality agreement will be entered;

(9) shepherd the due diligence process, during which the buyer reviews documentation relating to the company and its earnings through a Virtual Data Room ("VDR"), and meets with management and addresses any significant issues (such as related to quality of earnings, compliance, information technology systems, governance); and

(10) work with the seller and management to prepare for and complete the closing of the sale.[10]

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[10] *See Investment Banker in Sell-side M&A*, Corporate Fin. Inst.,https://corporatefinanceinstitute.com/resources/careers/jobs/investment-banker-in-sell-side-ma/ (last updated Oct. 13, 2022).

The lawyer also plays a critical role in the sale of the company. It is highly beneficial for the lawyer to be involved early in the sale process, before the LOI and confidentiality agreement are entered, to help address and prepare for legal and strategic issues that will likely arise later in the transaction, which helps minimize surprises for the parties. Most of the lawyer's work will be related to counseling his or her client in connection with development and finalization of the sale agreement and other transaction documents, especially with respect to the representations and warranties, indemnification and other provisions. The lawyer will lead negotiation and finalization of the sale agreement, working closely with the investment banker, the seller and management.

b. The Sale Process

The process of selling a company will generally take about 6 months, although that period could be shortened or expanded by a few months depending on facts that emerge during the process. In most cases, the seller will need to determine with the investment banker the number of potential buyers who are approached. Once the list of potential buyers is established, the sale process will generally involve the steps of: (1) transaction preparation; (2) initial solicitation; (3) bid refinement and final due diligence; and (4) negotiation and execution.

c. The Strategic Buyer's Perspective

When strategic buyers evaluate a company for purchase, they will typically focus on, among other things, whether the product and service mix of the company is complementary to what the buyer already has in place, e.g., due to geographical focus of the customers, employees and facilities, or the ability to capture more wallet share from customers.[11] They will also focus on whether the company can be integrated successfully

[11] *See* MARKS, ET AL., *supra* note 7, at 87-88.

into the strategic buyer from the perspective of facilities, systems, people and culture so that synergies (e.g., horizontal or vertical) can be created; if post-acquisition integration cannot be completed successfully, the benefits of the acquisition will turn out to be illusory.[12]

It is critical in post-acquisition integration that the members of the management team, and the other employees of the company, who the strategic buyer wants to remain with the company (recognizing that some management team members will be redundant with the addition of the management team of the strategic buyer) will actually remain; if the management team and employees leave in large numbers because they do not want to work for the strategic buyer, then that will often lead to loss of the anticipated revenues from the purchase and render the purchase a failure. The management team and employees will typically be incentivized to remain with the buyer through a mix of salary, bonus and incentive compensation such as stock options and earnouts.

V. Conclusion

Turning entrepreneurial ideas into new companies, and then growing those new companies into mature, major companies in their industries, is a complex process that is often opaque, even to professionals, and aspiring professionals, in these industries. Entrepreneurs and private investors who follow the best practices outlined in this article will maximize the prospects that the companies which they launch and grow will reach their fullest potential in their industries, and yield the innovation that drives the economic advancement of the country and the world.

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[12] *Id.*, at 212-16.