PE 'Buy-to-Sell' Strategy
vs.
Owners' 'Hold On' Tactic:

An Investment 'disconnect' in MENA

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1. Abstract

The PE model adopts a ‘Buy-to-Sell’ strategy. The sole purpose of a PE fund in acquiring a business -whether in full or in part- is to contribute to its value creation process, prior to reselling it at significant profits. The goal is rather simple and the roadmap clear. The incentives and interests are presumed to be in full alignment between the PE fund and the owners (if they still hold a stake therein) and/or management.

This ‘Buy-to-Sell’ strategy which consumes 3 to 7 years, has been hailed as the comparative advantage of PE over public companies. If a large public company acquires a suitable target, it is essentially to reap economic & synergetic benefits, and to integrate such target within its larger organizational structure. Whether that target delivers on its promised potential remains to be seen, since benchmarks of efficacy within a public company may not always be systematically and aggressively measured (*except for active serial acquirers such as GE, 3M, or Berkshire Hathaway*). Often, the CEO who is behind the decision to acquire the target is rarely the one who decides on shedding it, if it turns out to be a dud. Usually, the following CEO takes the scalpel and clears out the dead weeds left by the previous management. In the meantime, a laggard target can linger in the fold of a larger corporation for several years. A Buy-to-Own or a ‘Buy-to-Hold’ would be a more fitting description of this corporate pattern.

This scenario, which is often encountered in the context of M&A transactions led by public companies, has no duplicate in the realm of PE investments. In the context of PE holdings, efficiency is highly rewarded, turnarounds quickly carried out, subpar divisions swiftly discarded, and the business is put on a sale track within a prescribed period of time. The nimbleness of PE firms in implementing changes of drastic nature when and if required, cannot be matched by the geriatric pace of top-heavy corporations that are often governed by endless committees, taxing bureaucracies, and strict compliance with numerous regulations.

Generally, in Emerging Markets (“EMs”) and particularly, in the MENA region, the PE model sometimes conflicts with the ‘Hold On’ tactic in the framework of family-owned businesses. Said businesses represent, according to the most recent data, over 80% of private sector enterprises, a majority of which are comprised of medium-sized companies with revenues between \$50m to \$200m.

Family-owned businesses in MENA usually partner with a PE fund for two main reasons: (i) securing expansion finance (*with lesser strings attached than banks*); and (ii) ensuring continuity by preventing the business’ stagnation or, its takeover by a rival group or a larger company. No serious dilemmas are associated with the objective highlighted in (i) above. However, once freed from the concerns highlighted in (ii), family-businesses in MENA tend to stretch their ownership objectives and become –implicitly- proponents of a ‘Hold On’ tactic.

The definition of ‘Hold On’ by Merriam-Webster Dictionary is: *"if only they could hold on a little longer" -- keep going, keep on, survive, last, continue, persevere, struggle on, carry on, go on, hang on, hold out, not give up, see it through, stay the course.*

This paper purports to delve into the reasons, the challenges and the appropriate solutions to address this corporate 'disconnect' or clash of interests between the PE 'Buy-to-Sell' strategy vs. the owners' 'Hold On' tactic.

2. Geo-Political & Economic Factors

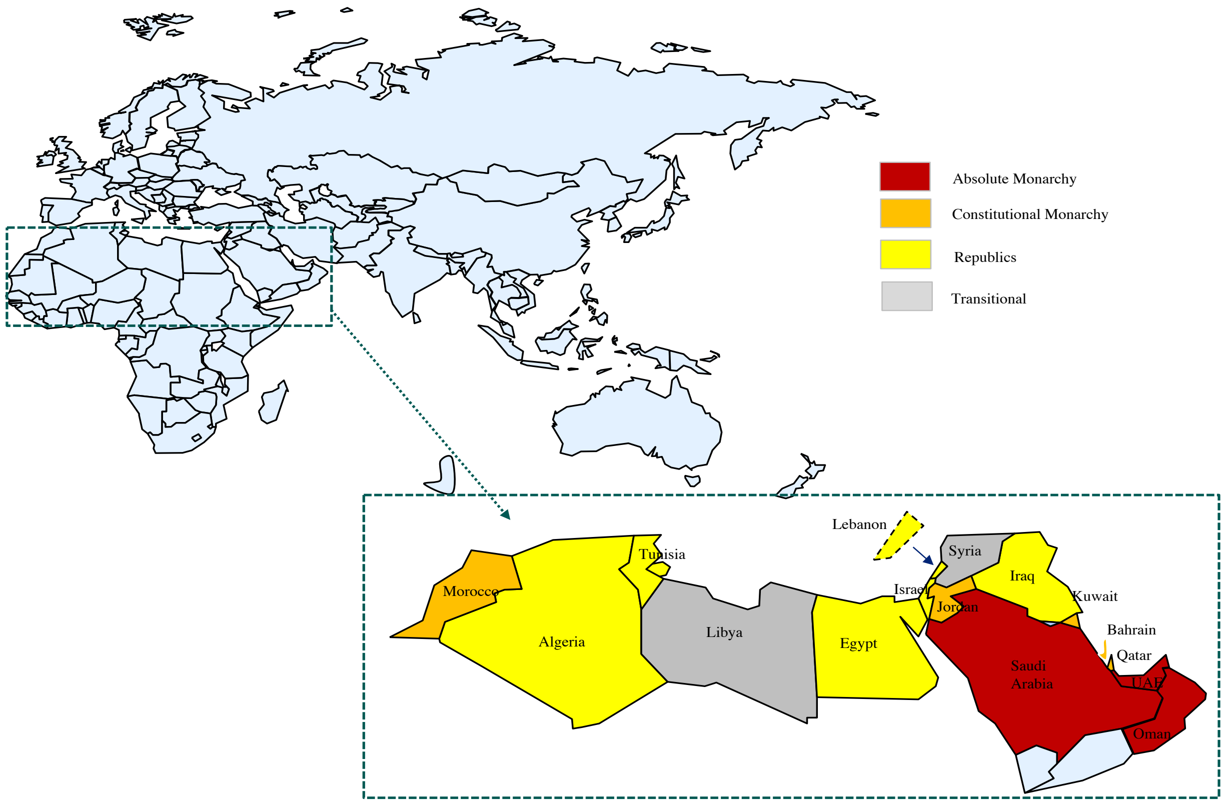
To start with, one has to get familiarized with the geopolitical and economic confines of the MENA region.

Politically, MENA is a region formed of 16 countries. Whilst the Arabic language is a common thread amongst them, government structures between countries differ sharply. Some countries are monarchies that rest upon historical tribal bonds with an underlying social contract closely knitted between the ruler and the people. At the exception of Jordan and Morocco, all said monarchies repose on vast reserves of natural resources that underpin their economies despite recent policies that aim to actively diversify into non-hydrocarbon industries and services. Other countries are republics with military-dominated governments such as Egypt and Algeria where deep social undertones and laborers' rights remain vividly present in the relations between the business community and the working classes, despite a nascent middle class that attempts to shorten the divide.

Economically, most, if not all MENA countries, exhibit a pattern of government control over key sectors: hydrocarbon industries (both upstream and downstream), large financial institutions including banks, insurers and re-insurers, mega healthcare service providers, key infrastructure (ports, airports, railways, highways, power generation plants, national grids), and real-estate development companies. According to the IFC, state owned enterprises ("SOEs") in MENA constitute approximately 50% to the GDP of the region with wide percentage disparities amongst countries. This disparity can be attributed to the political systems in place in different countries as presented in the table and maps below. For instance, countries with absolute monarchies such as Saudi Arabia, have a larger proportion of SOEs than do republics or constitutional monarchies. In Saudi Arabia for instance, the proportion of SOEs is close to 80% and state-controlled investors hold stakes in almost 50% of the listed companies. However, in republics such as Egypt and Lebanon, SOEs represent approx. 20% and 1% of GDP respectively.

The below table and map, summarize the geopolitical and economic landscape prevalent in the MENA region.

MENA Geo-Political Map



Source: Bertelsmann Transformation Index, Wikipedia

Political Classification Table

Country	Political System	Further Classification
Morocco	Constitutional Monarchy	Prime Minister is the nation’s active executive but considerable power is held by the Monarch to use at his discretion
Saudi Arabia	Absolute Monarchy	Power of Monarch is unconstrained by constitutional law
UAE	Absolute Monarchy	Power of Monarch is unconstrained by constitutional law
Qatar	Absolute monarchy	Power of Monarch is unconstrained by constitutional law
Oman	Absolute Monarchy	Power of Monarch is unconstrained by constitutional law
Bahrain	Constitutional Monarchy	Prime Minister is the nation’s active executive but considerable power is held by the Monarch to use at his discretion
Kuwait	Constitutional Monarchy	Prime Minister is the nation’s active executive but considerable power is held by the Monarch to use at his discretion
Lebanon	Parliamentary Republic	Prime Minister is the head of executive branch and the leader of legislature with executive power
Egypt	Semi-Presidential Republic	President and Prime Minister lead government where the president has executive power

Country	Political System	Further Classification
Libya	In Transition	In transition
Tunisia	Semi-Presidential Republic	President and Prime Minister lead government where the president has executive power
Iraq	Parliamentary Republic	Prime Minister is the head of executive branch and the leader of legislature with executive power
Algeria	Semi-Presidential Republic	President and Prime Minister lead government where the president has executive power
Syria	In Transition	In transition
Jordan	Constitutional Monarchy	Prime Minister is the nation's active executive but considerable power is held by the Monarch to use at his discretion
Israel	Parliamentary Republic	Prime Minister is the head of executive branch and the leader of legislature with executive power

Source: Bertelsmann Transformation Index, Wikipedia

A 2015 survey of governments in MENA conducted by the Organization for Economic Co-Operation and Development (OECD), found them holding a total of 2,111 SOEs, valued at $2 trillion and employing approximately 6 million people. Of the 10 largest listed companies, 50% qualify as SOEs as they include a state as a major shareholder. Hence, the state as a "capitalist" in its own right plays a significant role in MENA.

High level of state ownership is characteristic of nearly all Arab countries, oil-exporting and importing, in economies as diverse as Saudi Arabia, Syria, the UAE and Egypt. This principle can be linked to (i) the geopolitical map presented previously which demonstrates that economies are mainly dominated by a centralizing power structure with dominant executive rights; and (ii) still nascent capitalistic systems in which the state is involved in building infrastructures and developing the economies.

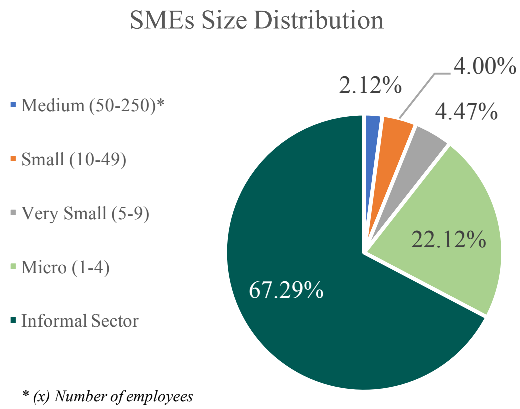
While significant state ownership is not unique to the MENA region, the complex structures of ownership, and multiple sovereign investors are more of a region-specific phenomenon. The world's most powerful sovereign wealth funds have sprung from the region starting in the late 1970s in Kuwait followed by the UAE, Oman and later in Qatar and Saudi Arabia. Other government-controlled investment companies also play a significant role in certain countries although the quantum of their investment objective remains diversifying oil-generated wealth into international assets classes.

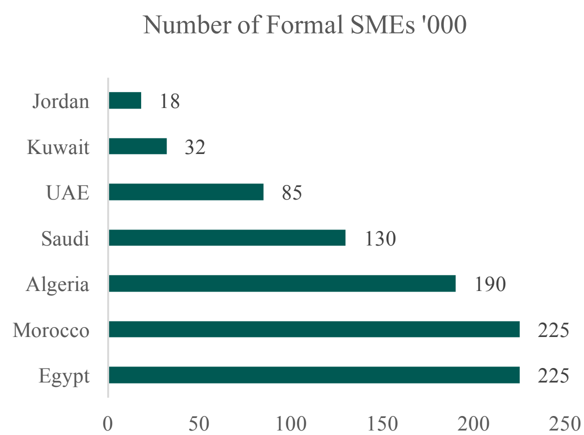
At the other side of the spectrum, over 80% of enterprises in MENA are SMEs (which constitute the majority of the remaining ownership structure besides SOEs). These enterprises have significant difficulties accessing bank loans and development funding from SOEs or large banks due to the lack of collateral (for instance in Kuwait, the percentage of total bank loans given to SMEs is as low as 2%).

A study released during the Sharjah Entrepreneurship Festival, noted that the SMEs (19m to 25m recorded SMEs in the region) present a potential of $920bln with 156% growth expected in the next five years. While the GCC region accounts for only 34% of all MENA SMEs, with around

$360bln revenues per year, or the equivalent of 26% of GDP, it has the largest potential for SMEs regionally, as it is growing from a relatively low base.

The below graphs present further information on distribution and sizes of SMEs in MENA





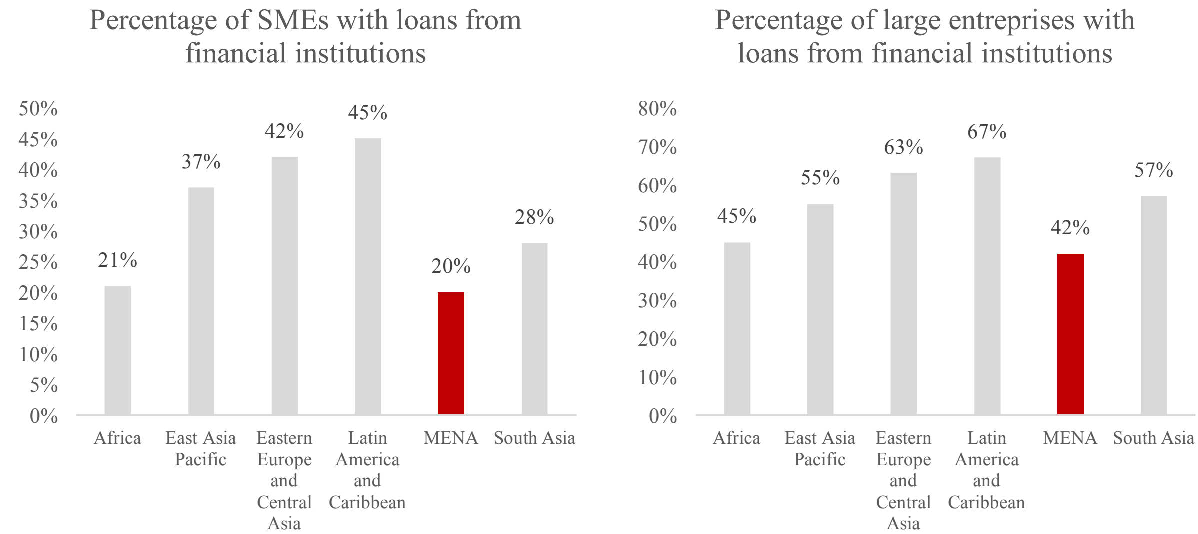
Source: World Bank Group's International Finance Corporation ("IFC") "Ecosystem Supporting SMEs and SME banking" 2014

Due to the potential of SMEs, MENA countries have recently initiated to increase the share of SMEs into the economy. After the oil slump, most MENA countries have recognized the need for diversification which can be provided by the plethora of SMEs active in a wide range of sectors. For example, in its Vision 2030, Saudi Arabia has set a target to increase the share of SMEs in its GDP from a current 20% to 35%. The UAE, in its Vision 2021, set a target to increase the share of SMEs in its non-oil GDP from a current 60% to 70%.

The below table from the IFC shows the most recent SME landscape in the region:

Country	SMEs Employment	% of GDP
Morocco	50%	38%
Tunisia	60%	51%
Egypt	75%	80%
Lebanon	82%	99%
Saudi	25%	Circa 20%

As demonstrated, the SMEs in MENA are becoming an increasingly important contributor to GDP and an important diversification factor, but still lags behind developed nations. This is partly due to the lack of accessible funding, hampering SMEs development. The total financing gap for SMEs in MENA is estimated at circa $220bln by the Middle East Investment Initiative. The below table compares the level of funding from financial instructions in EMs, emphasizing the large funding gap that MENA has, even when compared to its peer group in 2010. MENA financial institution funding comes after all EM's markets, including Africa, for both SMEs and larger enterprises.



Source: World Bank Group's IFC

As a result of this lack of funding, SMEs in the region rely heavily on the private sector -principally on VC and PE- to provide much-needed growth capital. The PE and VC sector invested $1.13bln in 2016 in the region's SMEs making them vital as a substitute to large institutions to fund long lasting, diversified economies through SMEs.

PE capital comes with lesser strings attached than banking loans. Except that PE comes with a conditional proposition: performance maximization with the goal of re-selling the business within few years at a premium. With time, this condition gets blurred, and becomes subject to flexible interpretations. This, in turn exacerbates the erstwhile aligned interests of the parties (i.e., PE and owners/entrepreneurs), leading to frictions, unnecessary delays and an opportunity loss if investments fail to be monetized in a timely fashion, the so-called corporate 'disconnect' between PE and owners-managers.

3. *The Cultural Setting*

Holding on to ownership stakes is a widespread sentiment amongst many (*but not all*) owners/entrepreneurs in EMs, and the MENA region is no exception to the rule. For many, owning one's business is a source of communal pride and a mark of financial independence. Furthermore, it is a sign of personal success and a tangible evidence of upward social mobility. Families have been associated with certain trades for generations, and keeping the family legacy alive at all costs, sometimes overrides the hard decisions needed to keep the business managed within strict financial and corporate guidelines. Buying and selling a business in MENA -in its most basic form- is not the norm, but rather a novelty that could carry the stigma of failure to holding on to a business.

The question most often posed in the event of an M&A in the mid-market segment, is why are the owners selling? Selling a family-owned business for pure profit is not a sufficient reason for the culture of the region. Is the business failing? Are the owners in trouble? Such are the instinctive queries that are associated with a change of ownership, as opposed to optimizing investments or maximizing returns. If it is doing well, why sell it, is a recurring theme in such instances. Simply put, when it comes to selling a business, the psyche in the MENA region bends toward a '*Mergers & Inquisitions'* approach rather than a straightforward '*Mergers & Acquisitions*' model.

The stigma associated with the selling of one's business becomes lessened in the case of a minority stake being acquired by a PE fund (*as opposed to an individual buyer or another family group*) even more so, when the PE fund injects fresh equity to expand the business via a capital increase. Hence, the welcomed reception of growth equity capital compared with a lesser volume of transactions involving the sale of majority stakes. Nevertheless, a minority stake remains in the minds of the sellers just as its name indicates, even if it comes with the contractual condition to re-sell the business at an agreed upon time interval.

Another dimension of the 'Hold On' tactic could be found beyond the cultural setting of the region, in the more global phenomenon of emotional ownership ("EO"). A starting point in human psychology is the 19th century psychologist William James who stated: 'The instinct of ownership is fundamental in man's nature'. In a healthy growing family, it is normal for the children to have a sense of 'owning their family and what it possesses'. This is the default condition that, in many instances in MENA, extends to owning a family business. This natural, and even legitimate desire cannot be successfully achieved without proper governance in place that regulates whom from the next generation ("NxG") is capable and ready to take over the business reins. Good governance could help in such situations. A family-owned business should have in place clear rules regarding NxG from time of entry into employment, to rotating into different departments, before lending (or not) in the C suite.

One should remember that EO, in a family-owned or first generation-led business is not felt solely by family members. Qualified and loyal managers and employees develop a strong EO towards their second home or second family too. That is a positive thread that unites all stakeholders and have to be stretched without unraveling.

Irrespective of family plans and desires of the NxG, a prudent and visionary owner/entrepreneur knows that success is premised on a series of principles:

- Prosperity comes from a set of comparative and competitive advantages
- One of the comparative advantages of any given business is its strong culture
- One of the components of such culture is EO for both family and non-family members
- EO should be an incentive for performance rather than a birth right

However, few owners/managers fully grasp the subtleties of EO and tend to elevate themselves and their offspring into key positions, without proper guidelines or roadmap, and hope that such succession will be accepted not on merits but on authority. The involvement of a partner PE fund could ease this passage, assist in devising a decision-making matrix, and ensure a more reward-based succession that would hold the business together firmer and longer.

4. Review of the 'Hold On' Tactic

The **rationales** used by 'Hold On' owners/entrepreneurs revolve around a mix of economic and certain cultural/psychological concerns including, *inter alia*, the following:

- *The founder's dilemma*: owners/entrepreneurs have founded the company and determined everything from the logo to the first employee, and from the first piece of furniture down to the selection and entry of the PE fund. They are best positioned, in their minds, to decide on when to sell, if at all.

- *The skepticism about exit routes*:

  (i) An IPO is nightmare #1: too much reporting and disclosure. Getting involved in a publicly listed company is a challenge, whereby leaving the helm to others is akin to a loss of control. IPOs are priced at a discount to fair value, and are subject to the whims and volatility of capital markets. Additionally, original owners will be locked-in for 12 to 18 months post-IPO without the possibility of monetizing their holdings.

  (ii) A trade sale is nightmare #2: owners will be asked to stay on board till a transition period is completed. Furthermore, they will be fully or partly guaranteeing unforeseen liabilities. After being the full owner, they become part-time golden consultants or glorified board members, without authority but subject to potential claims.

  (iii) A pass the parcel is nightmare #3: owners will be replacing a controlling but now familiar PE partner with a controlling but unfamiliar one. Owners will also be going for another holding cycle of 3 to 5 years, without any financial benefit from this secondary transaction.

- *Fear of the unknown*: now that the owner/entrepreneur has sold the business, what's next? She/he has no other trade, craft or special interest except the business. For some, retirement with liquid assets is less attractive than an active involvement even with illiquid assets.

- *The quest for independence*: given the opportunity, an owner/entrepreneur would rather find another source of finance including a bank to finance the buyout of the PE fund, and go back to owning 100% of the business.

The **perceived advantages** of a 'Hold On' tactic to owners/entrepreneurs comprise a number of factors that have to do with economic value and the 'power trip' of ownership control.

On value – for owners-entrepreneurs, time creates value. From a start-up level, the entity has become a fledgling business, and with time the business became a solid, profitable venture. The investment by a PE fund into the company, few years after its establishment, at a hefty multiple (*of revenues or EBITDA or P/E*) is an evidence that over time, such business has gathered steam, and attracted investors willing to pay a premium. In the mind of the owners/entrepreneurs more time equals more value. Therefore, delaying the ultimate sale is not necessarily viewed by owners/entrepreneurs as a resistance to the phenomenon of creating value but rather a desire to creating more of it. Viewed from the other side, the commitment of a PE fund to its LPs is to return the originally invested capital at a premium <u>but within a prescribed time frame</u> that maximizes IRR. This is not the commitment of the owner/entrepreneur to his or herself. In their majority, owners/entrepreneurs have no specific time constraint to abide by and no defined rates of return to deliver. For them, time is fluid, and the goal is simply more value. So, holding-on is synonymous to building-on.

On ownership control– owning a business cannot be judged from the sole prism of a financial statement, it is essentially a personal one. Ownership is one of the most efficient incentives for creativity, innovation and lifelong commitment. Even in public companies, stock ownership plans are devised to provide further incentives to employees by allowing them more 'skin in the game'. In family-owned businesses, the owner is the ultimate source of wealth and of welfare both to the family and to the loyal circle of employees making it a unique status within the corporate setting. The owner/entrepreneur is more than often the sole decision-maker on succession plans, promotions, demotions and bonus. Family members can be assured a role in the company, sometimes at the expense of more experienced non-members. Ensuring family legacy, and maintaining social cohesion are strong factors that lobby in that direction. Loyal employees can also count on the rewards and moral values of the founder at dire times. Mass layoffs are rare, closure of ailing divisions infrequent, and summary sackings of employees -even for grave mistakes- are atypical. This atmosphere is rarely disturbed by the entry of a PE fund that injects growth equity capital and ends up owning a minority stake. As a minority owner, the PE fund does not interfere in the day-to-day running of the business. Conversely, an exit, be it an IPO or trade sale, could wreak havoc on the established social-corporate equilibrium. So, holding on to the status quo is somewhat holding on to status itself.

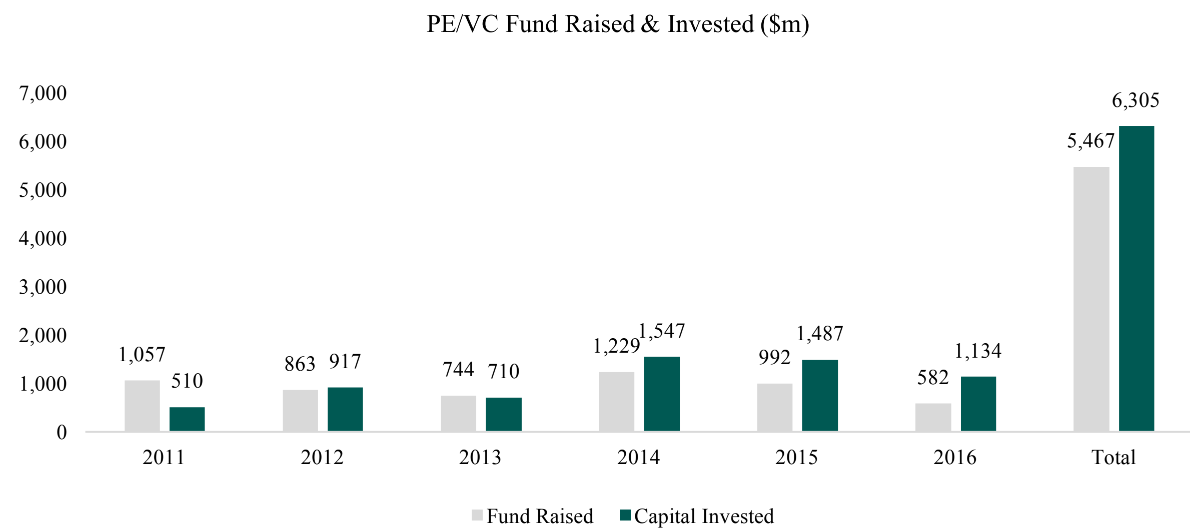
5. *The Case for the 'Buy-to-Sell' Strategy*

We maintain that the PE model in its growth equity subset works best for owners/entrepreneurs operating in the MENA region. Leveraged-buyouts have not been popular for a number of reasons including lack of appetite from local banks to lend aggressively for corporate acquisitions. The PE landscape has been divided between majority purchases and active minority investments, mostly financed by equity capital. Whilst potential clashes between PE funds and owners/entrepreneurs are well contained in the context of a majority acquisition, their likelihood significantly increases within the category of active minority investments that fit the growth equity model.

However, whether a majority stake or an active minority investment are involved, the PE strategy of 'Buy-to-Sell' bring benefits to the owners/entrepreneurs that no alternative financing can. Here below is a review of some of said benefits.

Massive Amount of Funding

The below graph exhibits the amount raised and invested in MENA over the past 5 years. Even though the PE sector is still a nascent industry in the region, that has witnessed during its development years, the 2008 global financial crisis, the 2011 Arab spring and the start of the oil slump in 2015, it has steadily invested in the region's SMEs. In total, in 5 years alone, the PE/VC sector has invested circa $6.3bln in the MENA economies, and despite regional turmoil, the investment level has grown steadily each year and increased investment values over the period by 122%.



Source: MENA PE Association and Deloitte "Private Equity and Venture Capital in the MENA region 2016"

No Interference in Day-to-Day Management and the Yielding of Collective Benefits

PE funds in the MENA region are, to a large extent, generalists. They seldom focus on one or even few sectors. They rather are opportunistic in nature. PE funds might prefer or seek to invest in specific sectors, for instance: education and healthcare. However, experience in the education sector, let alone in its sub-segments such as graduate studies, secondary or primary schools, vocational institutions, online courses, training and coaching, curriculum design, etc. is scarce amongst PE professionals. Hence, the generalist streak that characterizes PE funds operating in MENA yields lesser interference with portfolio companies. This almost '*laissez faire*' policy by PE funds is accentuated in the context of PEs that adhere to the growth-equity capital model. In such situations, the PE fund typically acquires a minority stake with limited elbow room to make waves within the corporate setting.

Irrespective whether a majority or a minority investor, the objective of a PE fund is value-creation and maximization, not day-to-day management. To do so, PE investors, at different degrees of success, provide added-value through: financial engineering, governance betterment, and operational enhancements. Reviewing each category on its own reveals that the nature and level of involvement fall outside the day-to-day operations of any business whilst quite benefiting the owners/managers.

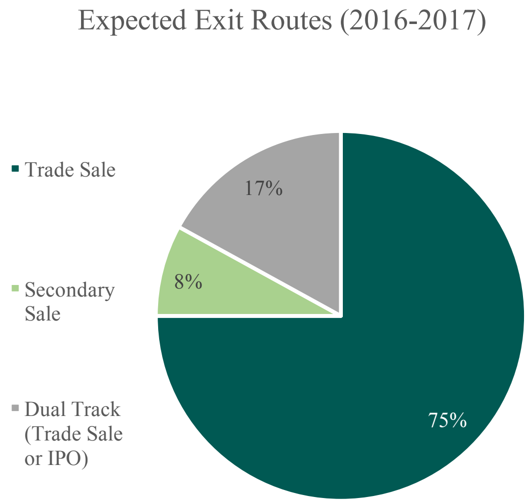
On financial engineering, the input/role of a PE fund is often displayed in the form of assisting in the renegotiation of the size and/or cost of current debt accumulated by the portfolio company. Pre-PE lending facilities are usually collateralized loans with high rates that are contracted to generate cash for working capital purposes. When a PE fund invests in a portfolio company via an equity injection, the capital base of the company is strengthened. Shortly thereafter, banks move away from requiring personal guarantees and granting asset-backed loans, to medium and long-term loans at commercial terms & rates. Pressures on management and costs on the company are thus removed by the time the PE firm enters. In later years, the PE firm may lend support to a portfolio company by negotiating on its behalf a follow-on acquisition. Support is translated into extracting the best terms from the target, and securing a bridge financing to close any gap between the final price and the equity consideration. Increased revenues, synergies and augmented profits typically ensue from such acquisitions maximizing value and thus returns from the 'Buy-to-Sell' strategy.

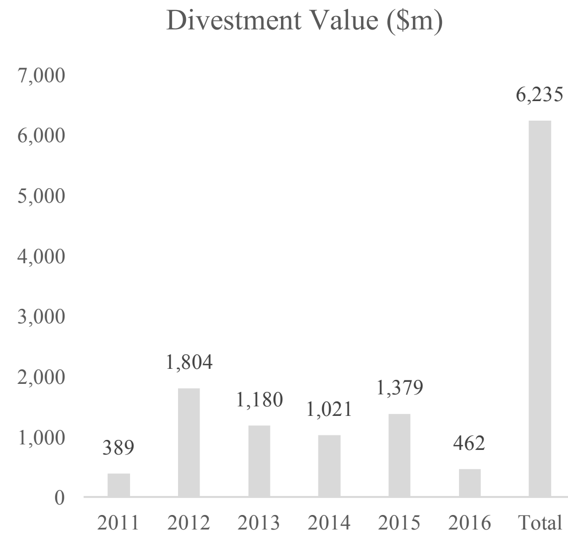
On governance betterment, PE funds require a proportionate representation on the boards of their portfolio companies. They rarely seek more except for adding independent members once the size and footprint of the business increase significantly, in order to ensure proper adherence to best practices and corporate standards. PE funds in the MENA region have seldom provoked total management shakeouts with the consistent exception of demanding the hiring of a qualified CFO. Such position is sensitive for a number of reasons, chief amongst them is being the central nerve system of any company. SMEs rarely hire such qualified person on their own volition and most do not see the need or fathom the cost, of hiring one. A PE fund's recent injection of capital which requires marshaling of the use of proceeds, updating of projections, setting-up performance matrices and reporting on financial status, render this hire a must for the portfolio company. The resulting financial clarity and discipline benefit the portfolio company at present and especially enhance its readiness for an exit sale be it to a strategic or financial buyer or even more so, in the event of an IPO, all in the context of a 'Buy-to-Sell' strategy.

On operational enhancements, rarely do PE funds venture into this area except when an issue becomes a true obstacle -not only to growth- and poses a serious threat to the viability of the business. In such rare cases the PE funds –in close coordination with the owners/managers- assist the portfolio company in selecting a third-party expert to devise solutions and implement the corrective processes. Hardly a day-to-day matter or a task that drastically interferes with the ways and customs with which the owners/managers have traditionally run their business. Also, operational enhancements translate into improved financial results, which can only be monetized when following a 'Buy-to-Sell' strategy.

Absolute Higher Returns

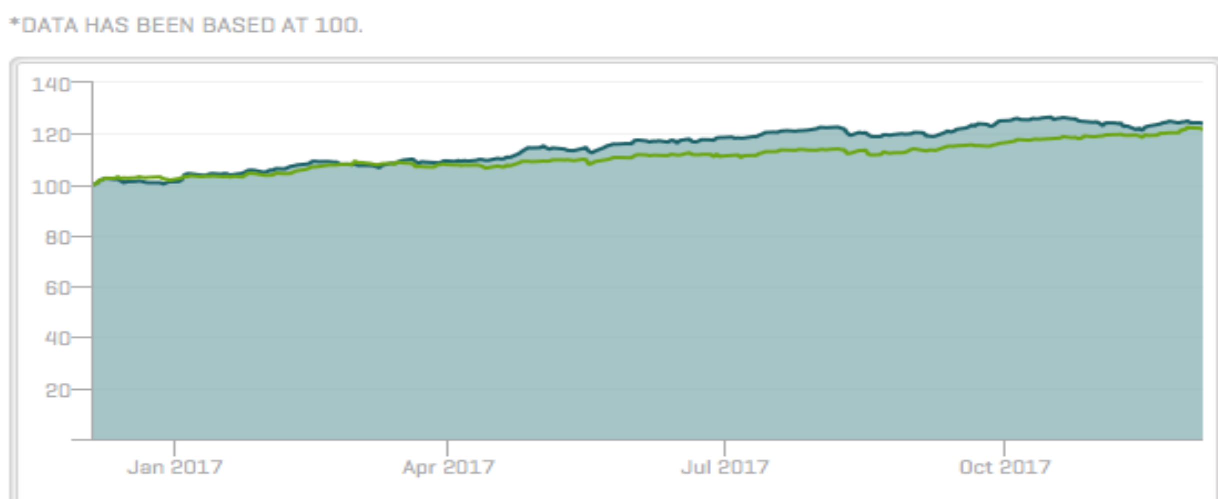
The PE sector realized a significant number of divestments in the region over the past 5 years totaling circa $6.3bln. Specific to the region, the preferred exit route is trade sale, although some other form of exits such as dual tracks are increasingly emerging.





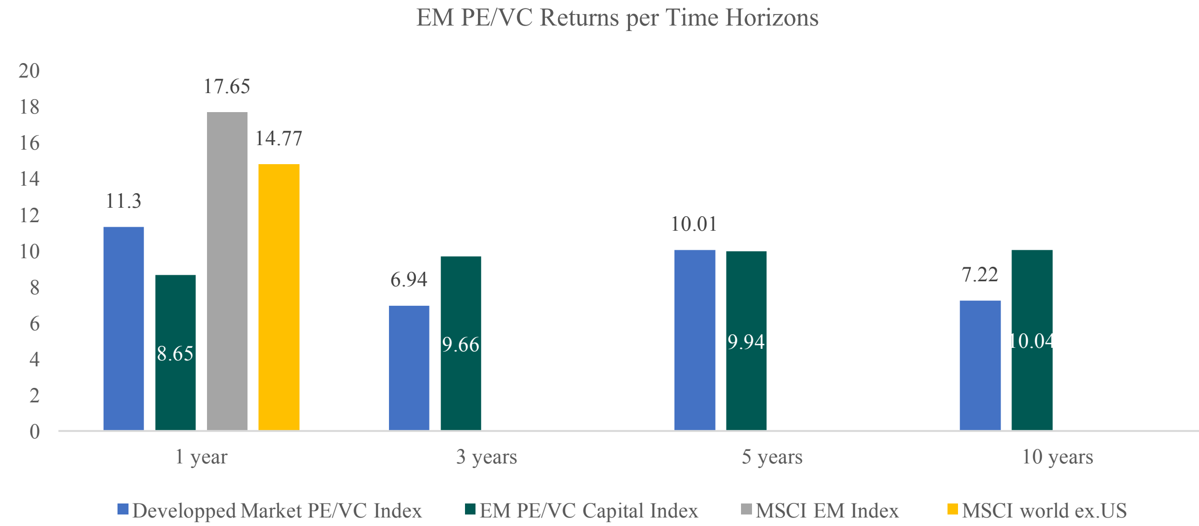
Source: MENA PE Association and Deloitte Private Equity and Venture Capital in the MENA region; Zawya

In addition to creating exit opportunities, the PE/VC sector has generally outperformed public markets globally. The below chart highlights the outperformance of the S&P index for listed PE against the S&P 500. Over the last year, the PE sector has outperformed public market companies.



S&P 500 ***S&P listed PE***
Source: S&P Dow Jones Indices

In EMs, the PE sector also performed extremely well compared to standard PE indices. The graph below graph demonstrates that in 2016-2017, the PE/VC in EMs outperformed the IRR of developed markets' PE/VC for the 3 years and 10 years horizons whilst performing very closely for the 5 years horizon. In addition, the EM MSCI index is by far outperforming the World MSCI index in the one year horizons.



**The index is a horizon calculation based on data compiled from 629 emerging markets private equity and venture capital funds including fully liquidated partnerships, formed between 1986 and 2016. The data and indices are fully fledged and provides by Cambridge Associates. They are pooled horizon internal rate of return (IRR) calculations, net of fees, expenses, and carried interest. The timing and magnitude of fund cash flows are integral to the IRR performance calculation.*
Source: Cambridge Associates Venture Capital Index 2016 and 2017

6. Areas of Contention & Proposed Solutions

Frictions between PE funds and owners/entrepreneurs of portfolio companies are not novel nor are they going to simply disappear. Even if interests are fully aligned, opinions often diverge, time lines alternate, and interpretation of what is better for the business can vary dramatically. None of the parties want but the best for the business, since all have a dear investment to protect, just like when raising a child. However, each is eager to inject its own form and dose of medicine that is expected, according to the party administering the medicine, to ensure a healthy and prospects-filled future.

Such issues may erupt between co-owners and co-managers of same business without necessarily the involvement of a PE fund. However, due to the institutional nature of a PE fund, certain areas of dissent are exacerbated. As an institution, a PE fund cannot simply rely on the instinct or emotions of the owner/entrepreneur when taking some of the key decisions that affect the business. Whilst such decisions are well within the scope of the executives, nonetheless they need to be adopted after a process of distillation that ensures the review and assessment of all aspects and consequences thereof. Also, as a legal person, a PE fund's definition of value and how it is created/maximized cannot be tainted with subjective views or personal preferences. Value is an intrinsic quantum that requires a cold, calculated assessment. Finally, a PE fund is by definition a transient owner of the business. Monetizing the investment is the quintessential reason for investing in the first place. A compromise needs to be struck between the need to harvest the investment and the desire to defer or prolong the harvesting period.

So, the areas of serious contention revolve around the (i) decision-making matrix: what are the critical matters, how are they decided and based on what set of data; and (iii) monetizing value/exit: how and when should the opportunity be harvested.

Decision-Making Process

The topic of decision-making should not be confused with that of corporate governance. Often owners/entrepreneurs of portfolio companies comply nominally with the requirements of corporate governance and estimate that such is sufficient to placate the demands of a PE fund. A board is enlarged with a pro rata representation reserved to the PE fund, committees are set up, and reporting and disclosure adhered to. However, the devil resides in the effective decision-making process not in the 'rituals' of board and committee meetings. What a PE fund is most concerned with is the process by which a critical decision is adopted. Therefore, good governance involves a lot more than compliance. Good corporate governance is a culture that is contagiously spread throughout the organization.

Hence, the challenge resides in instilling this culture into the family-owned or entrepreneur-led business. This cultural shift requires patience from the PE fund and conviction and gradual acceptance by the owners-entrepreneurs. The quicker this process is implemented the better for the business and all of its stakeholders.

It is noted at the outset that the decisions subject of this analysis are only <u>related to those matters that are not in the ordinary course of the business</u> such as: M&As, sale of all or substantially all of the assets, out-of-budget expenditures, long-term indebtedness in excess of a certain threshold, change of strategic direction, key appointments, and most importantly, exits. Broken down to its purest and most basic form, a decision-making process that satisfies both parties should not be an obstacle to growth or an area of disagreement.

Step 1: Identify the decision
Defining the nature of the decision that the business must make: legal, financial, commercial, strategic or a combination thereof. This first step is very important in order to focus the mind and efforts of the interested parties and decide whether expert advice is needed. *This task is best left to the owners/entrepreneurs.*

Step 2: Gather relevant information
Data collection is primordial before making a decision: what information is needed, the best sources of information, and how to get it. This step involves both internal and external data mining. *This task is best left to the owners/entrepreneurs.*

Step 3: Identify the alternatives
Identifying all possible paths, avenues and alternatives. *This task might require the views of the PE fund and/or an expert opinion.*

Step 4: Weigh the evidence
Drawing on information and experience and not on emotions help in testing/assessing the alternatives to the end. In this step, the alternatives must be listed from the most desirable to the least desirable. *This task needs to be discussed openly and without prejudgment between the owners/entrepreneurs and the PE fund.*

Step 5: Choose among alternatives
Once all the evidence is weighed, the parties are ready to select the alternative that seems to be the best for the business. *This task requires a buy-in by both the PE fund and the owners/entrepreneurs*.

Step 6: Take action
This simply is the implementation phase of the alternative chosen in Step 5. *This task is best left to the owners/entrepreneurs*.

Step 7: Review your decision & its consequences
If the decision has not met the identified need, repeating certain steps of the process to make a new decision would be necessary. *This task requires a consensus by both the PE fund and the owners/entrepreneurs*.

The allocation of tasks in the various steps of the decision-making process reinforces the bond of trust between the parties whilst avoiding any encroachment on executive authority.

Monetizing Value/Exit

A leitmotiv complaint from owners/entrepreneurs is that PE funds are quick to impose their views on the ways and means that a business should be disposed of. Such claims could arguably apply in the context of a portfolio company owned at majority by a PE fund, and where the majority shareholder is using its democratic right to vote a prescribed path to monetize the investment. In the context of a PE fund that has a minority stake in a portfolio company, the shoe is more likely to drop but on the other foot. Meaning that PE funds suffer from the resistance to sell by the owners/entrepreneurs despite a binding legal agreement on the part of all parties, to specifically do so.

One needs to separate the legitimate claims from the dubious ones in reviewing the areas of dissention between the parties in the event of an exit.

<u>Timing</u>: no party should or can sell a company if markets are in turmoil, or if conditions are not conducive for such a sale, be it a trade sale or an IPO. This is a legitimate reason that applies to both PE funds and owners/entrepreneurs, and the insistence of either party on going through with a sale under ill-timed circumstances, if at all possible, can simply be value-destructive.

<u>Pricing</u>: no party should or can sell an investment at less than an accepted rate of return that meets their economic and other expectations. This is a legitimate reason. Usually, PE funds after a 5 to 7 years period require a 2.5x return on their invested capital (or an implied IRR of 20%). For owners/managers –leaving EO aside- such return translates into almost 5x since the owners' capital originally invested in the portfolio company is modest compared with that of the PE fund. Still, this does account for the years of efforts and toil invested in the company, but nonetheless a return acceptable to a PE Fund usually translates into an exponential return to the owners/entrepreneurs.

<u>Exit Route</u>: no PE fund that owns a minority stake in a portfolio company can impose a specific exit route onto the owners/entrepreneurs. A PE fund can 'block' a specific exit route but cannot

impose one. Even this ‘blocking’ right is dubious and cannot apply in practice. The reason being that an exit is usually tailored to the characteristics of the company, and to the goals of the owners especially if in key positions or holding a slight majority. Indeed, certain companies do not reach the scale required for an IPO, while others are typically poised for a strategic M&A because they fill the gap in a larger company’s strategy. In certain instances, the owner/entrepreneur is willing to run the business for few more years and suddenly an IPO becomes a suitable proposition. In different circumstances, an owner/entrepreneur is eagerly looking for retirement and a trade sale with a short transition period is the preferred route. Hence, the ‘blocking’ decision or the ‘forcing’ will of a PE fund in such recurring situations, is dubious at best.

However, whether the timing, pricing or exit route are agreed or not, and whether the owners/entrepreneurs are willing to abide by their binding agreements or chose the tactic of procrastination, the dilemma of the PE fund, especially one that follows a growth-equity capital model remains unfazed. How to monetize on an investment after a certain period of gestation in a manner as to realize the financial returns to LPs? A PE fund should not be held hostage of the desires, legitimate or not, of the owners/managers not to sell the company, in part or in full, without any means of breaking-out from such an investment.

The most frequently used method to address equitable dissociation from an equity investment between a selling PE fund and a holding-on owner/manager, is to make the PE Fund’s minority shares subject to buyback by the company and/or the owner/entrepreneur. In this context, a share buyback agreement from a PE fund is like vesting for stock options. Based upon some defined schedule and conditions, the company and/or the owner/entrepreneur has the obligation to buy back all, of the PE Fund’s shares. Conditions that trigger the implementation of the buyback obligation are cumulative and include: (i) a specific period of time (say a time past the 7th anniversary of the investment); and (ii) the exhaustion of all suitable alternatives (failed attempts to conduct a proper exit during the past 2 years). At such time, the parties would need to agree on a valuation method and on the mechanism of pricing and payment for the shares. This is generally achieved by appointing a third-party appraiser to conduct the valuation of the company using various methods. In turn, this adviser will issue a ‘fairness opinion’ on the price range of the shares that shall be adopted within a percentage of difference, by all parties. Payment for the shares could be subject to a separate schedule agreed upon between the parties. Title to the shares and all rights attached thereto (dividends and voting rights) shall remain intact and exercised by the PE fund till the payment of the last installment. This is meant to ensure a diligent execution of the buyback protocol.

Another solution would be to ‘convert’ the common shares held by the PE fund (when the cumulative triggering conditions are fully met) into a senior note (the “Note”) whose principal’s value is equal to its pro rata share in the capital of the company, based on the same valuation method applied in the buyback scenario. The Note will be senior to all except existing long-term bank debt. Furthermore, the Note will be payable in 6 months and shall bear interest (or not) at commercial rates. Non-payment of such Note within a certain period (e.g., 6 months) would increase the financial costs (if applied in the first place); and thereafter (e.g., within 12 months of issuance) if such Note is not settled in full, the company would be considered in default.