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Minority Investments – Small PE Trend, Big Benefits for Business Owners

By Michael Richmond

One of the more interesting new trends in private equity funds is the increasing willingness to make minority investments in the middle market space. Private equity firms were doing a limited number of minority investments until the last few years. While this area still represents less than 5% of overall M&A activity, there has been a recent uptick in minority investment activities from PE firms. Such investments pose advantages, as well as challenges, to both investors and business owners.

A minority investment is one where the investor owns less than 50% of a company and does not otherwise have a controlling interest. By selling a minority share of the business, the business owner can obtain capital while maintaining control of the business.

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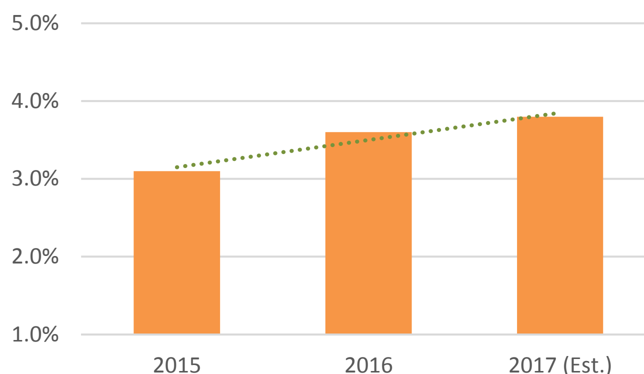
This approach is useful for business owners who are seeking growth capital, but are uncomfortable relinquishing control to a private equity firm. It also presents an opportunity for an owner to obtain outside experience and resources that would otherwise not be available.

However, this approach does have its disadvantages. Selling a minority investment will generally yield a valuation that is discounted 20 – 40%, as compared to standard PE investments that require a controlling interest.



*Source from FactSet Research Systems

Capital from a minority investment is appropriate in situations where it will elevate the company to a higher level of growth not possible on its own. The expanded growth could ultimately result in a valuation well in excess of the "discounted" value at the time when the capital is raised.

The payback period is an additional consideration that is important for evaluating a minority investment. Will the business owner achieve enough value growth to justify both the discount and the additional partner in the business?

A simplified example, which excludes the time value of money, will illustrate this point. Say an owner is selling a minority interest resulting in a 30% return on investment. Despite the discounted value, the improved earnings will result in an overall higher valuation for the owner in less than two years. However, if the investment yields only a 5% return, it would take 4 – 8

+-years to break even, likely not making the transaction worthwhile

Even if a business owner continues to maintain control of the business, the minority investor will have some important rights. Often, a convertible debt instrument that has a defined maturity date will provide these investments.

Even equity investments will generally have certain "put" rights that may force a sale of the business before the business owner would otherwise want to sell.

Whether the investment is made in the form of debt or equity, the minority investor will typically require:

- regular financial reporting
- access to other information
- a seat on the board of directors
- a voice in some of the operations of the business.

In addition, a minority investor may require that its consent be obtained for certain company activity, including incurrence of additional debt, and other fundamental rights. Under some circumstances, a minority investment may be the best source of capital for business owners that provide benefits which could not be achieved otherwise. However, each owner should understand the costs and obligations before pursuing this strategy.

About the Author

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