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Equity-worthiness and equity-willingness: Key factors in private equity deals

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Abstract While access to private equity funds (PEFs) provides a unique opportunity for firms to set up sturdy growth paths, how PEFs select companies is an unknown process to entrepreneurs and business owners. This study aims to offer insights regarding the private equity market to entrepreneurs searching for external capital. We analyzed a novel dataset of 240 pre-deal negotiations between small- and medium-sized Italian companies and a closed-end fund. Results indicate that the successful closing of a deal depends on more than just the target firm's equity-worthiness (i.e., the company's ability to meet the expectations of a private equity investor). In fact, there is another dimension: the target firm's equity-willingness (i.e., the company's motivations to accept an outside equity investor). We summarize the results of our study by building a 2x2 positioning matrix on the basis of the target firm's equity-worthiness and equity-willingness. This matrix enables entrepreneurs to grasp how private equity investors evaluate their firms.
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1. What makes a company appealing to private equity funds?

Today's business complexity and uncertainty may make access to external financing challenging, especially for privately held companies. These difficulties are more pronounced when emerging technologies are involved in firm strategies. In such a case, business opportunities frequently require irreversible investments with high sunk costs, and the stock-return predictability is uncertain. Companies can respond to the aforementioned challenges with the financial support of private equity funds (PEFs). Globally, PEFs manage around $1 trillion in capital. They can provide a unique opportunity for firms to implement growth strategies by expanding their equity base (Berger & Udell, 1998; Metrick & Yasuda, 2010).

Although entrepreneurs are frequently committed to closing private equity deals due to genuine interest in significant equity injections, many of them fail to really attract PEFs' attention. Anecdotal evidence suggests that less than 3% of pre-negotiations

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between privately held companies and PEFs lead to the closing of a deal. This means that the process is exacting; roughly 97% of negotiations set up and initiated by PEFs collapse (Prowse, 1998; Sahlman, 1990).

As the deal flow of PEFs is very demanding, it is important that entrepreneurs and business owners understand what makes a company an attractive target for PEFs. Too often, firms see the private equity process as a 'black box' and consequently provide misleading signals regarding the distinctive essence of their entrepreneurial potential. For example, when presenting their businesses, owners may overly emphasize long-standing traditions and valuable links between the family and the firm. Rather than heightening the firm's allure, this alerts the PEF to potential future trouble in devising a possible divestment through the sale of the entire company to a strategic acquirer. Entrepreneurs may also show strong aversion to loss of control over long-term strategic decisions regarding the company (Bradford & Smith, 1997). Nonetheless, no PEF wants to invest in a firm in which it is not able to influence new strategic trajectories. In a nutshell, entrepreneurs may be a barrier to themselves when closing a private equity deal. Arousing the interest of investors is very tricky for entrepreneurs if they ignore the determinants that lead to a successful or unsuccessful PEF process.

To help entrepreneurs become more familiar with PEFs' methods for evaluating firms, this study looks inside the private equity process. We analyzed 240 pre-deal negotiations between small- and medium-sized Italian companies and a closed-end fund. Engaging in an in-depth field study allows us to provide an overview of the drivers that cause breakdowns in potential deals during the scouting process. Further, we suggest future measures to entrepreneurs and business owners that enhance the effectiveness of the scouting process. This study provides privately held companies with insights regarding the ways in which PEFs choose their investments. Next, we describe the barriers to receiving PEFs. We then discuss the principal features of our study and present an in-depth field analysis on the investment decision process of a PEF.

2. Barriers to the private equity investment process: A closer look

A private equity deal is typically carried out when an institutional investor provides a significant amount of equity capital to a privately held company that is believed to have good growth potential and is usually unable or unwilling to go public (Gilligan & Wright, 2012). PEFs scout out good investment opportunities and produce returns for investors by selling the company again after a few years (Zacharakis & Meyer, 1998). PEFs expect that the value of their stake in a target firm will be considerably higher thanks to the enhanced investment capacity and more effective corporate governance and control systems.

Entrepreneurs and business owners are strongly interested in attracting PEFs' attention because firms thereby receive financial resources, which are particularly helpful for those that lack tangible assets and cash flow and operate in rapidly growing fields (e.g., high technology). More generally, PEFs remove obstacles to firms' growth by means of the new complementary resources and capabilities that they can supply (Fenn & Liang, 1998; Lerner, Sorensen, & Strömberg, 2011).

Because PEFs are habitually unwilling to disclose information regarding their internal procedures, entrepreneurs have only a rough idea of the building blocks of PEFs' business models. The lack of available data on scouting processes and the reluctance of private equity investors to disclose information regarding their failed deals has impeded a deeper understanding of this phenomenon (Fenn & Liang, 1998). For entrepreneurs, the private equity process is a hurdles race that involves four key steps: (1) deal origination, (2) screening, (3) analysis/evaluation, and (4) deal structuring (Tyebjee & Bruno, 1984).

2.1. Step #1: Deal origination

PEFs scrutinize new deals, starting with scouting activities carried out by consultants and PEF investment managers. Generally, PEFs take a proactive origination approach via database queries, web scraping, social media, business meetings, and expert networks (Teten & Farmer, 2010). However, privately held companies frequently suffer from difficulties in attempting to enter a private equity network (Batjargal & Liu, 2004). For example, too often a company's website hinders the scouting process because the website is not user-friendly and enlightening, making the firm less attractive to potential PEFs. Furthermore, correctly searching for external capital in the private equity market is often very time consuming and expensive for a privately held company, especially if it is small. Because business owners are involved in managing short-term activities, they do not find time to make up for the lack of information about the private equity market and tend to postpone longer-term choices, such as a private equity deal.

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