PERMANENT
EQUITY

Rolling Equity

If you (a business owner) have talked to any advisors or investors about selling your business, chances are you've heard the phrase "rolling equity." A roll represents the equity you are not going to sell in the transaction. If you're talking to people about selling, why do the responses focus on not selling? Because a roll is one of the few structural elements of a deal with which everyone can collectively win.

Role vs. Roll

When designing a deal that can work for all parties, it's helpful to distinguish between operational and ownership needs. For owners, an extremely reasonable transaction goal can be to change his or her operational role. But an equity roll has very little to do with your operational role.

The role anyone plays in operations should be determined by where his or her skill sets, relationships, and institutional knowledge overlap with the needs and opportunities of the business. This means that some owners should be CEOs, and some will best serve both their companies and their own interests in entirely different functions. With any potential investor, post-close roles can and should be an open discussion.

It's also okay to acknowledge that you do not want to play an active role in operations long term. Depending on the business, that may be impossible to achieve on Day One (while still getting a fair value), but whether it's a desire to fully retire or a recognition that you will not play well with others, it's better to be upfront so that there's ample time to make plans and train others accordingly.

By contrast, a roll is not about how you spend your time day to day. As defined on the post-close cap table, your roll outlines what share of accountability, risk, and reward for the company's performance you are willing to take on going forward.

Roll Signals & Value

If your response to that last paragraph was, "I should have zero accountability or risk after I sell," you are probably making several assumptions. If you've ever done a real estate deal, you know liability can linger. And those transactions lack the added complexity that comes with people. Selling your business is not like selling, well, anything else.

Selling 100% of a company is an option if you can find a willing buyer. But a full sale means that you are expecting them to assume all accountability at close, which is expensive (and why it may be harder to find a willing buyer). Given the risk premium extreme, you can expect to receive the lowest value for your business if you insist on a full sale for all cash at close.

There are ways to move away from that extreme to increase overall value to you, while still selling all the equity. Whether it's a seller note, a contingent payment, or some other mechanism, if you are willing to be paid later, and especially if you are willing to tie deferred payments to the future performance of the business, you can ultimately receive more over time.

Keeping more of the accountability and risk by rolling equity is the best way to maximize value. And that tradeoff can pay off. Through a willingness to help protect an investor's downside, you also retain the opportunity to enjoy the upside if things go well.

For an investor, the magnitude of your roll can be a signal on your confidence in the business' health and future prospects. Therefore, a willingness to roll forward 10% sends a different message than rolling forward 40%. If you strongly believe in the future, so will they.

Rolling Math

As with most elements of deal-making, rolling with a traditional private equity firm is somewhat different from rolling with Permanent Equity. So let's walk through the basic inputs for each.

Traditional Roll
A traditional private equity fund will likely own your business for 3 to 5 years. So you are rolling forward for that specific term upfront. Then, depending on your operating agreement, you may or may not be agreeing to future rolls with other parties. During the initial term, the firm's ambition will be to grow the earnings of the business as much as possible in order to position the business to be sold for significantly more to the next buyer because of its increased scale.

Most often, the business will operate with debt during this period, with more debt being added as other companies are purchased and folded into operations (known as "inorganic growth"). This means that there is unlikely to be much free cash flow, so your "second bite of the apple," as it's commonly referred to, will occur when the business is next sold.

The price and terms under which the business is next sold will determine your outcome. Typically, the valuation has to exceed several hurdles (e.g., repayment of debt on the business, minimum return to the private equity fund) in order for you to begin to receive a share of the proceeds. If the business is sold to certain types of buyers, your initial proceeds may be in the form of restricted stock or some other form that may take additional time to liquidate.

A traditional roll can work out very well. By enduring the sprint over several years, if you are collectively able to grow earnings significantly, new buyer sets can become available who are willing to pay higher multiples for a more scaled business. Your personal outcome is highly dependent on the terms.

Permanent Equity Roll
Permanent Equity uses 30-year funds to invest with no intention of selling. So when you roll forward with us, there is no one-time "second bite" optimization, but rather a wide variety of ways to manage your equity over time. Like other firms, we invest in businesses to grow them, but with a lens towards that growth being healthy for the core business' long-term prosperity.

In order to preserve that prosperity, we avoid transactional debt. We want to have control over how to use cash flows, both in good times and bad. While there may be an outlier year from time to time, in an average year, business models we invest in do not use all of their free cash flow for reinvestment needs. This means that we can make meaningful distributions to ownership. And in rolling forward, you receive your share of those distributions.

Effectively, distributions represent many small bites off the proverbial apple in future years. But do we expect you to roll forward for 30 years? Not unless you want to.

And so over time, there can be opportunities to sell your shares to the company, to Permanent Equity, or to another operator in the business using a commercially fair valuation.

The other opportunity is not to sell your shares. You can put the equity in a trust for your kids or grandkids. Beyond maintaining relational ties to the brand and team, we regularly say that if you don't have to sell the investment you know best (namely, your business), patience can pay off.

How Everyone Can Win

Rolling equity works when the resulting partnership achieves more than the sum of its parts. You are giving up some level of liquidity and keeping responsibility. The investor is giving up total control over future economics. And you are both willing to do that if you think that by working together, the business will be better for it. Over time, that strength should translate into compelling financial results for you personally.

Liquidity and ownership are not mutually exclusive, but the question is what you want from a transaction. Compounding the value of your ownership stake in a way that is true to the brand and sustainable for the company takes time and the right partners, but it can expand the options, resilience, and value of what's next for you and your business.

Rules for Rolling

As with any element of a deal, a good outcome when rolling equity depends on the people and the terms involved. When considering a roll, keep the following in mind:

1) Believe in the buyer. Hopefully this goes without saying, but do not roll forward with someone you do not trust. Any deal is going to require some faith. Every buyer is human and will make some mistakes. But rolling is effectively partnering, so choose your partner carefully.

It is also okay to ask for references. Out of respect for others' time and the likelihood of a transaction, it's customary for these introductions to be made in diligence. Keep in mind that every deal is quirky in its own way, but assessing whether others value their partnership should be achievable.

2) Have faith in the future. If you do not believe the business will do well (or you do not want it to do well – a real emotion some people struggle with) in the future, rolling forward keeps you tied up in what may increasingly be a messy situation.

And sometimes that messiness is less about results and more about people. Some people are not wired to work with or for someone else. The worst version of a partnership is one in which a founding member becomes a source of toxicity within the team culture. Either be for the team, or don't be on it.

3) Measure risk and reward. Nothing written on this site should be taken as personal investment advice, but terms are worth understanding in granular detail on any illiquid investment. What has to occur in order for you to receive proceeds? How? What could be asked of you?

As one example, what happens if there's a capital call by the company to purchase a competitor? Are you expected to participate? What happens if you don't? Would you want to?

In any partnership proposal we make at Permanent Equity, we try to spend a substantial amount of time understanding what a good shared vision for the future looks like. Those discussions involve ideas about how to grow the business and things to invest in. But we spend at least as much time talking about what they individually want to do, want to be involved in, and what would frustrate the heck out of them. Because while rolling equity is largely discussed as a financial term, the best outcomes often occur when you actually know, like, and respect each other. Basically, when you want each other to win.