Words of Wisdom—Minority Shareholders in Your PEO

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Minority interest is defined as "a significant but non-controlling ownership of less than 50 percent of a company's voting shares by either an investor or another company." A minority investor can own a very small percentage or as much as 49.9 percent. In most cases, minority investors are not actively involved in the day-to-day PEO business.

Within a public company, minority shareholders are those who choose to own shares of publicly traded stock and, in such cases, there are clearly defined regulatory guidelines that dictate appropriate disclosure and governance. For purposes of this article, we will focus on minority ownership in privately held PEO companies.

A PEO company would typically sell minority shares to raise capital and/or to bring additional expertise to the internal senior management team and board of directors. We most commonly see minority shareholders in privately held PEOs as part of an original investor group. The original investors often participated in start-up capital and were part of the PEO owner's professional friends and/or family network. It is less common in our industry that minority shareholders are brought in years after inception.

All shareholders or investors seek a return on the money they invest—be it in public stock or directly in a company. Minority investments are much less common in business service firms, such as PEOs, than in companies with hard assets. Why? The ROI is more risky with companies who build the business on client relationships and contracts versus a company that holds tangible hard assets that can be sold quickly should the company, the economy, or the particular industry experience a worst-case scenario. For example, a manufacturing company that has a physical plant and machinery would be able to sell those assets if the company went out of business. The proceeds would be distributed to all shareholders based upon percentage of ownership. In the case of a business services firm, other than a few desks, chairs, and computers, there are no solid assets upon which a shareholder could be guaranteed monetary return.

Should you choose to seek minority shareholders, consider these words of wisdom:

- Few minority investors make an investment without conditions that result in restrictions and loss of flexibility for the PEO owner. These may include veto power over executive compensation, decision-making power over raising additional equity or debt, or perhaps veto power over the ability to make capital expenditure decisions.
- Typically, minority investors hold a board of directors seat and have the right to replace the executive team if agreed-upon performance targets are not met.
- If you have a loose governance structure, prepare for a more formal one with minority investors. Understandably, all investors want regular information about how their money is being spent and how the company is performing.
- Should a minority investor choose to cash out, the value of her shares is worth less than that of a majority owner. Because minority shareholders do not have the direct authority to run the business, a "minority interest discount" is applied to the internal value of those shares. A lack of marketing discount and lack of voting right discount may also apply, making the value even lower.
- If your PEO business is having terrific financial performance, you are making all the right decisions, and the business is growing by leaps and bounds, you may feel compelled to "buy out" the minority investors. Understand that they will want to continue to "ride the coat tails" of your hard work because they will make more money in that scenario. Buying back shares from an inactive shareholder when the PEO owner did all the work is often hard to stomach. However, in difficult business times, that same minority investor may want to exert substantial pressure on the PEO owner to do what it takes to get the business back on track.

Finding the *right* minority investors may be difficult, but can also be a tremendous asset to your company as it grows. They may not only bring money to the table, but can provide executive-level expertise, support, and advice in good and bad times. Occasionally, a minority investor will want a first right of refusal when the owner chooses to sell, and in the cases when the minority investor has truly been a business partner, that can work well for all involved.

With today's economic environment and financial challenges, capital investments of any kind will be more difficult to procure. While capital is available, many prefer a "sure thing" return should economic conditions continue to decline. Additionally, the HR services sector has been hit hard by unemployment and hiring trends. Minority investors are difficult to find in good economic times because they do not have much control and they do not get their money back easily. Today's economy makes this an even more daunting task.

And remember, there are alternatives to finding minority investors:

- Bring in an angel or venture capital investor who you will pay an agreed-upon sum of money over an agreed-upon time frame; or
- Go it alone. Doing well in the good times, knowing that you will be the sole provider for additional cash during more difficult times. At the end of the day, should an exit/sell be part of your plan, you will receive 100 percent of the proceeds of the sale!

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