IDEAS | PEOPLE | TRUST

Private Equity

What is Private Equity

DEMYSTIFY | NAVIGATE | ACCELERATE | REALISE

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BDO

BDO – Demystify

Private Equity investment enables entrepreneurial businesses to expand at speed, and clears the way for skilled and ambitious people to step up a gear.
If managed in the right way, Private Equity can be an exceptionally positive route to growth.

Read the next in our series:

Navigate

Appropriate if your business has reached a stage where speaking to Private Equity and preparing for potential investment is on your agenda.

Using Private Equity should be a positive experience, especially for those doing it for the first time. It can help entrepreneurial leaders professionalise, grow and achieve transformation in their business by having support from investors who will have many years of experience, and realising profit for all shareholders, typically over a three-five year period. Private Equity houses are often tarnished by the headlines of a rogue few, but in reality there are very few real predators out there looking for an opportunity to take advantage.

Deciding that Private Equity is the right choice and finding the right partner for your business is a big decision.

This document is designed to help you understand how Private Equity works and what to consider before you decide to take on a Private Equity investor. If you have questions about the process, or want to discuss your options for investment you can contact our team of Private Equity experts, who can help you make the right decisions for your business. Our experience is founded on years of helping entrepreneurial clients get the best out of their businesses, and our Private Equity team can do the same for you.

Jamie Austin
Global Private Equity Leader

Valuing your business

Businesses that grow the fastest, turn their efforts into profits and cash the most readily and where the risks are the lowest will be valued the most highly. So, when considering whether you should take on Private Equity, it is worthwhile looking at your business through these four lenses:

- How fast has your business grown, and how fast could it grow in the future?
- Companies that are able to grow fastest attract the highest valuations

- How much effort (cost) do you need to make to turn your revenues into profit and what could be done to improve that?
- Companies with high margins are more highly valued by investors

- How readily does your profit turn into cash and what could be done to enhance that?
- Private Equity houses use debt to reduce the cost of capital and help drive equity value. Companies with high cash conversion can service more debt

- How 'risky' is your business? How resilient is it should bad things happen?
- Companies that are seen as less risky are more investable. Visibility of earnings, ESG responsibility and good management reduces risk perception

If you combine all these together, you reach the highest valuations.

Valuing your business

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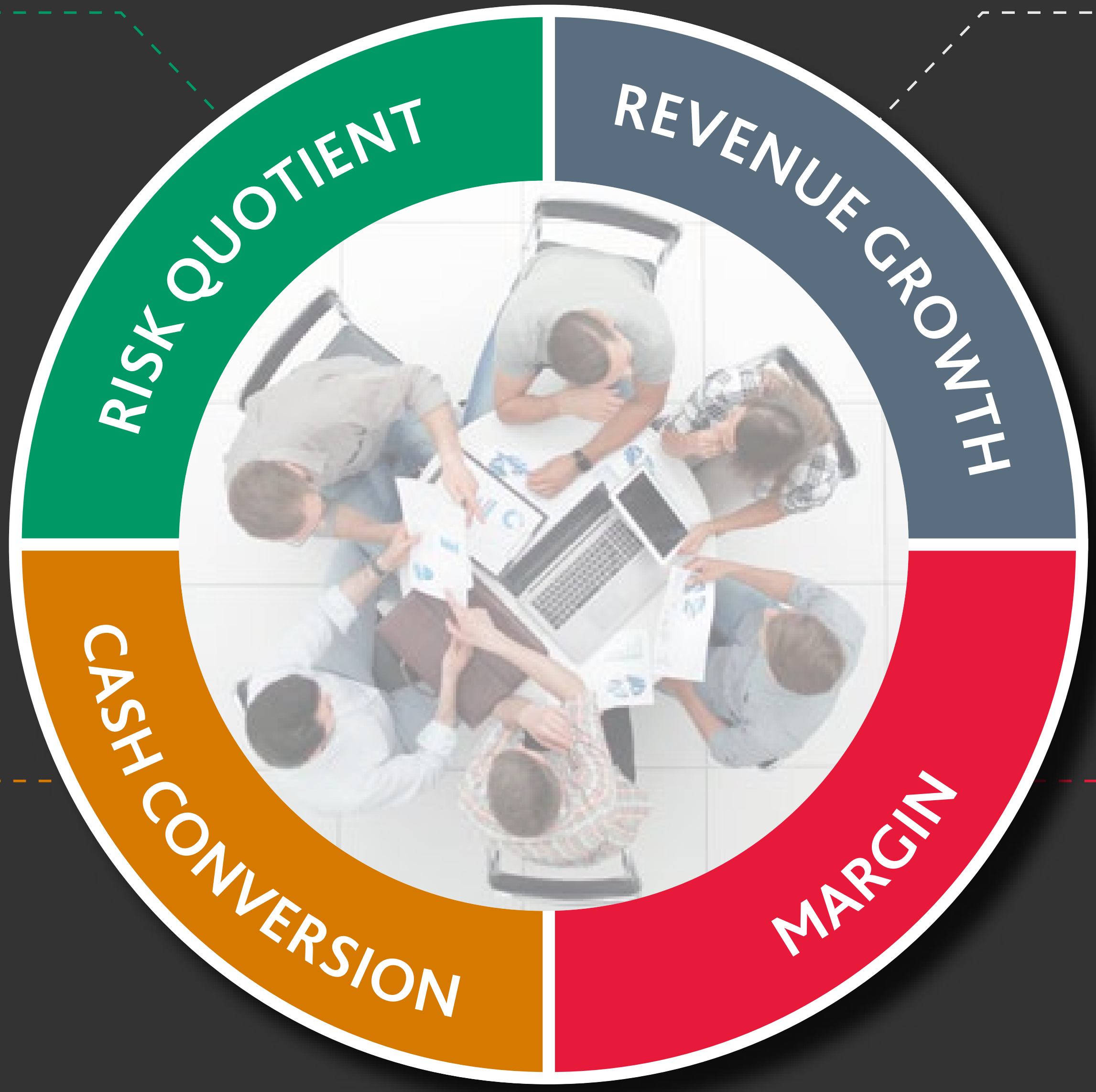
In our experience, there are four areas which should be focused on in order to drive and maximise your value. Some considerations in each of these areas are set out as follows:



- Quality & visibility of earnings
- Quality of management info
- Strong management team
- Corporate governance
- Diverse customer base
- Systems & controls
- IT & cybersecurity
- Lack of liability

- Volume
- Pricing
- Sales mix
- Maximising brand and IP
- Business development practices and team
- Use of social media and online presence
- Leadership in a growing market

- Working capital
- Capex
- Tax
- Financing

- Efficiency / productivity
- Scale
- Cost control

Over the past 10 years **Private Equity backed businesses** have produced **17.5% returns** compared to **7.7%** from the **public markets**

How does Private Equity work?

Private Equity

Private Equity (PE) is a term given to investment monies that are aggregated into funds for investing predominantly into private companies. These investment monies come from pension funds, insurance companies, sovereign wealth funds, high net worth individuals, families and individual investors. Typically, Private Equity funds are closed ended and have a 10 - 12 year life. This is an important factor to take into account when considering Private Equity investment, as where a fund is in its life cycle does influence its investment behaviours, which is important for business leaders to understand. Generally, funds will be invested for three to five years but the investment duration could be longer if it makes commercial sense.

What is a Private Equity house?

A Private Equity house is a generic term applied to businesses that invest PE investment monies on behalf of the funders (pension funds, insurance companies etc.) they are advisers to the fund and are normally a separate legal entity with a different ownership group.

The PE house can also be referred to as the fund manager and/or General Partner – known as the 'GP'. This is because many PE houses are structured as limited partnerships - there is a general partner (the PE house/fund manager) and there are limited partners (the pension funds, insurance companies etc whose funds are managed by the PE house) – known as 'LPs'. The fund's terms will also invariably require the PE house/team to invest its own money in the fund too.

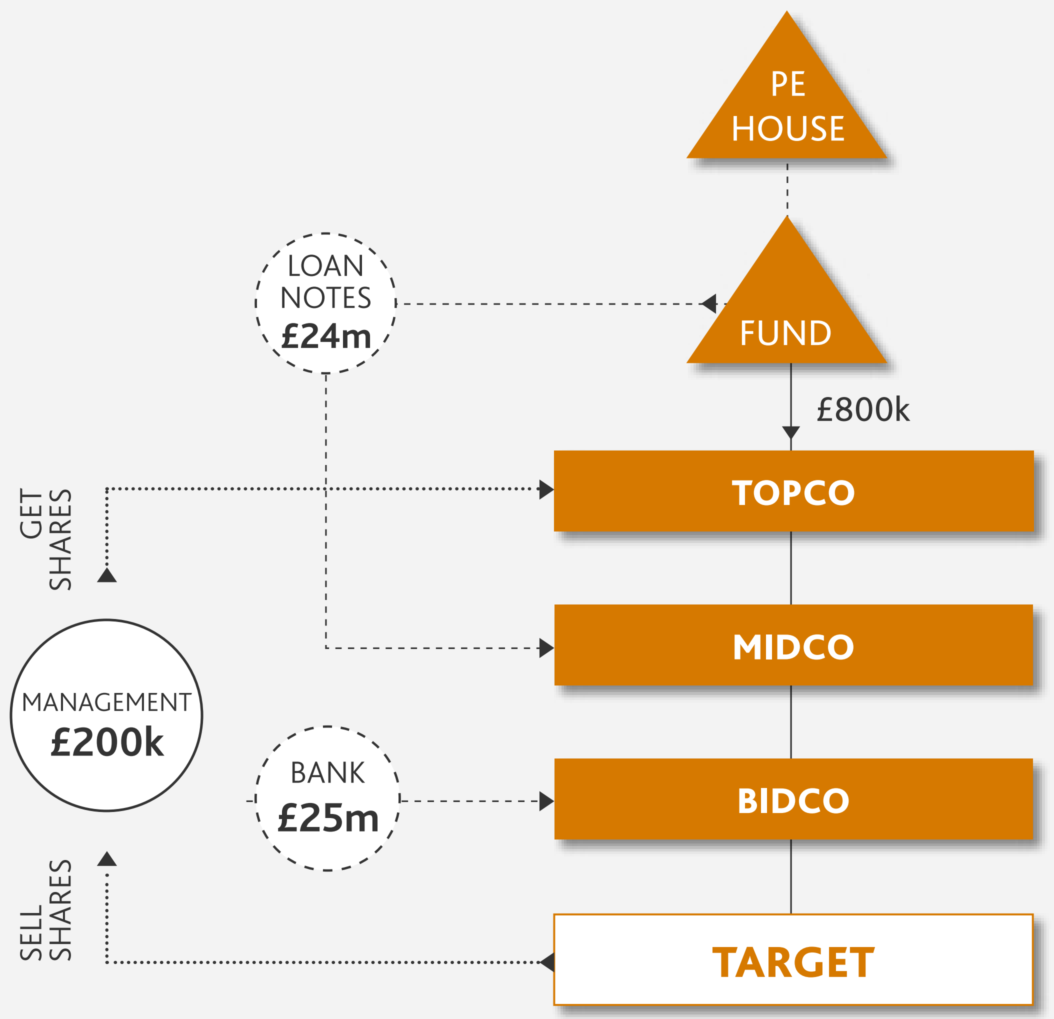
What is carried interest?

Typically, the PE house will charge a management fee to cover the running costs of the PE house and a carried interest, or 'carry'. The carried interest is an agreed proportion (usually 20%) of the profits of the fund. The carry begins to accrue once the LPs have made a specified return (typically 8%), and eventually results in an 80:20 split of fund profits between the LPs and the carry. The carried interest is split up amongst the team members of the PE house. Senior team members will also be asked to invest in the fund in their own right. In that way, the investment managers, executives and partners are all aligned with the success of each investment in the portfolio.

PE houses usually tackle different parts of the market.

- **Size/ 'cheque size'**: small cap (up to £50m); mid cap (between £50m-£350m); large cap, (£350m and over)
- **Geography**: some are restricted to invest in one geography, for example the UK (LDC); some are international, covering Western Europe for example (Equistone); and some are global (CVC, Blackstone etc)
- **Sector**: technology; healthcare life sciences; manufacturing etc.
- **Stage**: growth; stressed; distressed
- **Type**: majority or buy-out; minority or partnership capital; development capital; venture.

Typical structure



How does Private Equity work?

continued

How does Private Equity buy a company?

The funds controlled by the PE house are invested into a new company (often referred to as 'Newco') which is formed just to make the acquisition of the target company. The funds used to form Newco are not just sourced from the PE house (typically in the form of a relatively small amount of ordinary equity with the balance as loan notes, or possibly preference shares or preferred equity, subject to tax and legal structuring advice), but often also from the vendors of the target company and, invariably, the management team. The capital sourced from the PE house is referred to as the 'institutional strip'. The vendors and the management team often roll over a proportion of their equity in the target company into loan notes and ordinary equity alongside the incoming PE house. If the proportions and the terms are broadly the same, they are said to have invested in the institutional strip. The management team will invariably be asked to invest in the venture from their own resources; this is so all stakeholders have 'skin in the game'.

The ownership proportions of Newco are determined by the value of target, the relative amounts of funding provided (bank debt, loan notes, vendor rollover and management investment) and negotiation. There are no hard and fast rules, but the more negotiating power the vendors and management have, the better their packages will be. The element of the ordinary shares owned by the management that does not form part of the institutional strip is referred to as 'sweet equity'. This is because when the plan is met or exceeded, the percentage growth in value of this equity should far exceed the percentage growth in value of the institutional strip. For a sense of proportion, if the institutional strip (the funds put in by the PE house and rolled over by vendors or management) is expected to double in value over the period of the investment, then the value of the sweet equity might be expected to grow to 10 times its initial value.

Over the period of the investment, the cash generated by the target company may be used to pay down the bank debt, and sometimes the loan notes. However, most of the loan notes and the balance of the bank debt (often the majority of that) are repaid at exit (ie, when the shareholders sell their stakes). As the returns on the bank debt and loan notes are restricted to the repayment of the principal plus accrued interest, any excess growth in value accrues to the ordinary shares - very much like how equity value accrues to house owners who use mortgages.

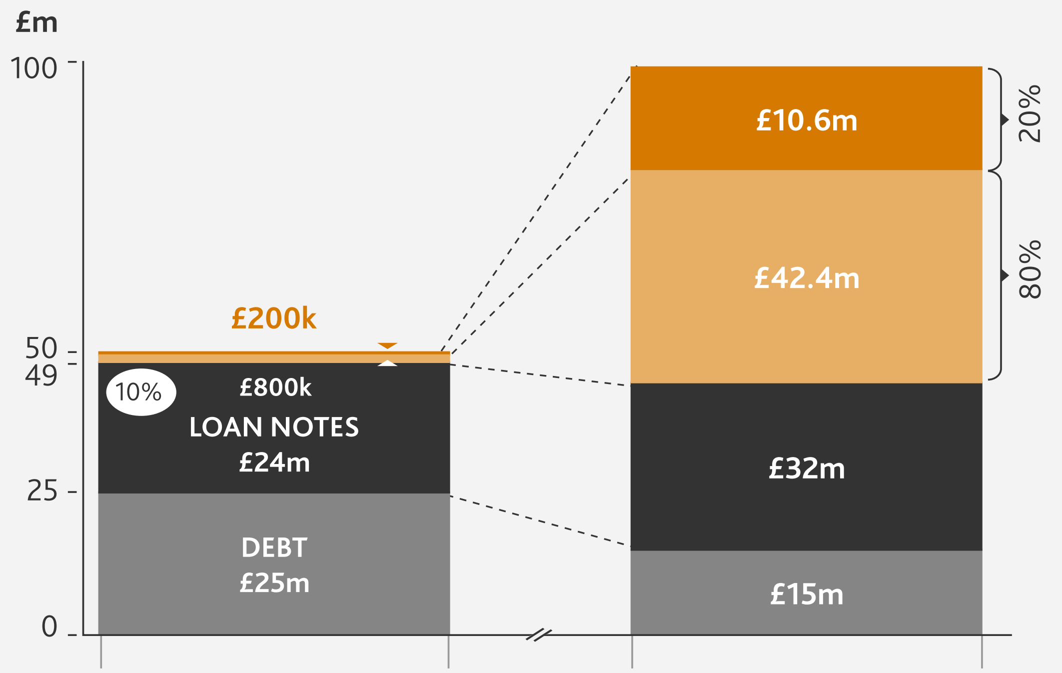
The majority of Private Equity buy-outs are funded through loan notes or preference shares from PE houses and bank debt. Bank debt attracts an interest rate that is paid periodically. The loan notes attract an interest rate (or 'coupon'), typically of between 8% and 12%. The coupon can be paid but is most normally rolled up into the principal or paid by the issue of further notes, referred to as 'PIK' (payment-in-kind) notes. The balance is funded by a thin sliver of ordinary equity.

How will it work day to day?

What the structure of your business and its management looks like will vary depending on the deal with the PE house. Sometimes, the investor will take a board seat, appointing someone from the PE house. There may be new schedules and structures for board meetings, and some investors will be very 'hands on' with management teams.

Often, PE houses have dedicated portfolio teams, focused on managing the investments. A portfolio team will take over from the investment team that you may well have built a strong relationship with. The handover from investment to portfolio team should be done as soon as possible, to allow you to develop a relationship and settle any questions.

Driving value into ordinary shares



	YEAR 0	YEAR 3
EBITDA	£5m	£10m
MULTIPLE	10x	10x
EV	£50m	£100m

How does Private Equity work?

continued

The importance of the CFO

PE houses place significant importance on the quality of your people, so will look at the experience and competence of your whole management team. This is especially pertinent for the CFO or Finance Director. The right CFO will create value, not just protect it, because bankers and investors place heavy emphasis on the role. Their appetite to lend or invest will be enhanced when a strong CFO is running a smooth process, and your business will be more likely to strike the right deal and get better terms.

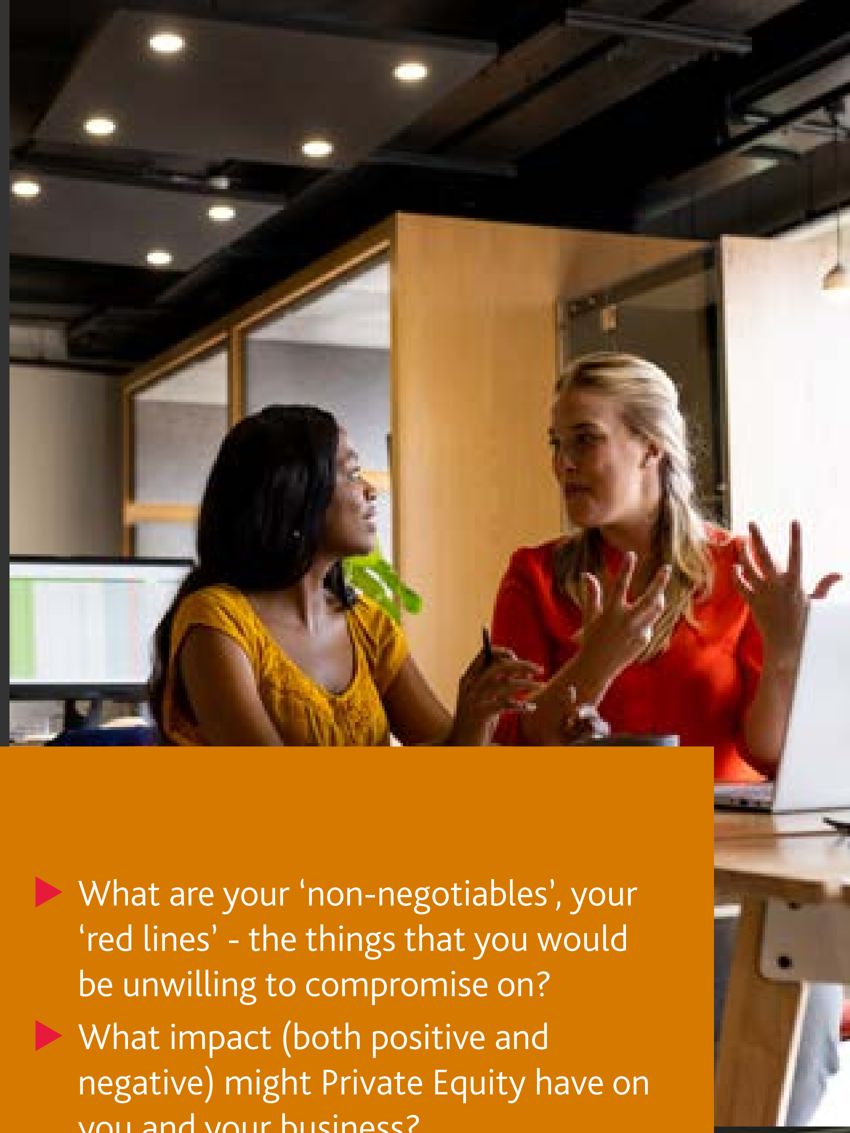
For the CFO and the finance function, the most important thing to demonstrate to investors is the ability to make full use of the complex financial and management information needed to drive the transformation and growth that the investors expect. After the deal, the PE house will rely on your CFO and finance function to deliver high quality management information, together with relevant key performance indicators (KPIs). Your PE investor will be focussed on the future, closely watching earnings, profit and operational cash generation against what are likely to be ambitious forecasts and budgets.

How Private Equity makes money

As time progresses, all being well, the business and its EBITDA (earnings before interest, taxes, depreciation, and amortisation) grow, bank debt is paid off or amortised, the operations of the business are improved and the value of the business will increase. This drives value into the ordinary shares, provided that the growth outstrips the total cost of debt and of the loan notes. The value of the equity grows further if there is 'multiple accretion', which happens when the exit multiple exceeds the entry multiple. As you would imagine, executives in PE houses not only focus on growth of the EBITDA but also in all those things that might positively affect multiples. This will include keeping a weather eye on the market and the timing of any exit.

If everyone has done their job well, timing is picked well and the business has been prepared for the sale process efficiently the returns can be excellent for the fund, the PE house, its executives, the vendors and the management team.

Is Private Equity right for you?



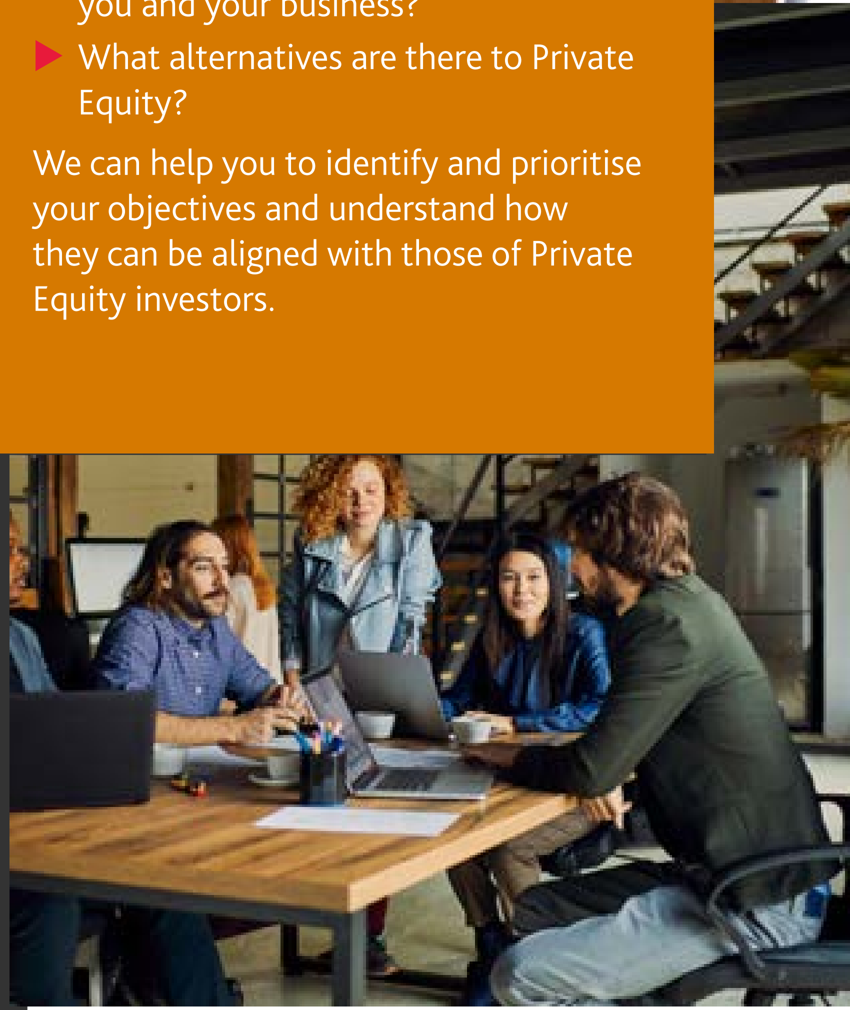
Your management team will be well aware of the importance of agenda alignment amongst the leaders of your business. This comes into even sharper focus when a Private Equity investor joins the board.

The agenda of your investors is likely to be just to drive value. Investors may not share the altruistic objectives of your team, although there is considerable growth in impact investing. Real success in a relationship with Private Equity comes where there is significant alignment, and non-aligned factors can be clearly de-prioritised. It is important to have absolute clarity about your own objectives and those of your team before deciding to look for an investor.

Questions you might find it useful to pose include:

- What is your definition of success for yourself and for your business in the medium to long term?
- What is your business plan (your strategy) to achieve this?
- How much investment do you require to fund your business plan?
- How much money would you / the vendors like to take out?
- How could you accelerate your plans and grow your business faster?
- How risky is your business? Do you have sustainable plans and financing without investment?
- What are your 'non-negotiables', your 'red lines' - the things that you would be unwilling to compromise on?
- What impact (both positive and negative) might Private Equity have on you and your business?
- What alternatives are there to Private Equity?

We can help you to identify and prioritise your objectives and understand how they can be aligned with those of Private Equity investors.



Contact us

Read the next in our series:

NAVIGATE

Appropriate if your business has reached a stage where speaking to Private Equity and preparing for potential investment is on your agenda. This will help you to navigate your way around Private Equity and investors.

we want to hear **from you**

The reasons for embarking on Private Equity investment may be complex, but whatever your motivation, we are searching for ambitious businesses to champion through this chapter and enhance future growth.

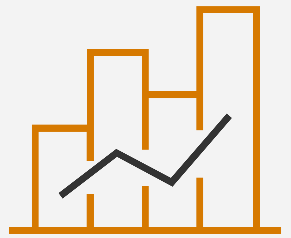
Contact **Jamie Austin** on +44(0)77 7192 8208 for more information.
We look forward to meeting you and learning about your business.

Definitions and stats in this document have been sourced from industry bodies PitchBook Data, BVCA and ICAEW ('A Guide to Private Equity'; 'Private Equity Demystified').

Private Equity in numbers

Private Equity specialists: The BDO team

BDO's Private Equity group is a highly collaborative network of more than 400 experienced advisers from all disciplines across the firm including audit, tax, M&A, transaction services and corporate advisory. This practical team has a profound understanding of the Private Equity industry, particularly in the mid market. Our people are part of the process at every level, interacting with funds, advising on deals, and working closely with portfolio companies to help them realise their goals.



Our PE specialists are located where Private Equity is investing.

The investments we've made in infrastructure, resources and talent mean that we offer a powerful combination of service, scale and expertise; and through our deep working relationship with each client we can focus on their unique needs and deliver practical individual solutions.

We've never lost our agility and personal approach. We understand the intense pressure that comes with the challenge of entrepreneurial growth, and we work strategically alongside our clients. Private Equity can offer huge rewards to businesses, but knowing how to manage it effectively makes all the difference. That's where our team comes to the fore.

Private Equity definitions

Auction	A process in which an investment bank or other corporate finance adviser invites several Private Equity houses to look at a particular company that is for sale and to offer a bid to buy it.
BIMBO	Buy-in-management-buyout. A combination of a management buy-in (MBI) and a management buy-out (MBO).
Capital Markets	A marketplace in which long-term capital is raised by industry and commerce, the government and local authorities. Stock exchanges are part of capital markets.
Carried Interest	An entitlement accruing to an investment fund's management company or individual members of the fund management team. Carried interest becomes payable once the investors have achieved repayment of their original investment in the fund plus a defined hurdle rate.
Conditions precedent	Certain conditions that a Private Equity firm may insist are satisfied before a deal is complete.
Covenant	An agreement by a company that certain activities will or will not be carried out or that certain thresholds will be met.
Debt Fund	Alternative lenders who are often used in PE transactions rather than corporate banks. Typically constituted as a fund in a similar way to a Private Equity fund.
General Partner (GP)	An entity that raises capital from limited partners for a fund and determines which assets the fund should invest in.
Institutional Buy-out	A buy-out initiated by institutional investors, such as Private Equity houses, where they take a controlling interest in the business.
Leveraged buy-out (LBO)	A buy-out in which the Newco's capital structure incorporates a level of debt, much of which is normally secured against the company's assets.
Leverage	The use of debt in an investment, including for acquisitions and capital expenditures.

Limited Partner (LP)	An entity that commits capital to a general partner's fund.
Management buy-out (MBO)	A management buyout (MBO) is the most common type of PE transaction, which allows the existing management team, who perhaps has no or little equity ownership, to buy all or part of the business alongside a PE house
Management buy-in (MBI)	A transaction in which external managers take over the company. Financing is provided to enable a manager or group of managers from outside the target company to buy into the company with the support of Private Equity investors.
Payment in Kind (PIK)	An instrument that pays interest or dividends to investors of bonds, notes, or preferred stock with additional securities or equity instead of cash.
Sweet Equity	An instrument in the form of options, performance rights, or rights to further shares that increase the value of management equity relative to other shareholders. Often issued at a lower price to motivate management with the incentive of a higher upside when objectives are achieved.
Secondary Buy-out	A buy-out in which a Private Equity house sells control of a portfolio company to another Private Equity house.
Venture Capital	A type of Private Equity investing that focuses on start-ups and early-stage companies with long-term, high-growth potential.

Want further help demystifying Private Equity?

Download our e-book - An insiders view.

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