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Private Equity / Venture Capital

Overview

Private Equity or Venture Capital refers to financing arrangements where the source of money that has financed the transaction is a private fund, specifically established to invest in private companies, rather than public quoted securities or bonds. Private equity transactions obtain their money from a wide range of sources such as pensions funds, banks, and insurances companies, high net worth individuals and government agencies.

Private equity transactions provide capital for start-up projects, funding for development capital or may provide finance for a buy out by a management team. A management buy out is where existing management buys out the business from its owners, commonly with the assistance of a private equity investor. A management %buy in+ is where a team is assembled by the private equity investor to acquire an existing business.

In an auction process, the seller of a business invites private equity providers to compete against each other to acquire the business. The internet boom in the late 1990s led to an increased appetite for start up and development capital investments. However, the subsequent collapse emphasised the high risk nature of private equity transactions.

A buyout is a process where an existing management team or a specially assembled management team acquire a business from the current owners with the help of private equity financer. A new company is usually established which will act as the investment vehicle. Another new company will typically be formed to acquire and hold the assets or shares of the existing business.

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Private Equity Providers

Private equity providers usually manage funds for their investors. They will have internal rules which must be followed before an investment can be made. These rules are usually set out in the agreements entered into, when the funds are set up.

A private equity provider will investigate a potential acquisition and prepare a paper. This will then be considered by the investment committee who will usual comprise of senior members of the fund management team. The executive is responsible for the investment and will have to justify why the investment is made and set out the likely pitfalls and likely returns. The investment committee approval in principle is usually obtained prior to any offer being made.

Private equity providers will usually have a procedure for draw down of funds. An independent trustee or custodian usually holds cash on behalf of the fund as part of internal control and assurance. They will need to ensure that the investment is within the fundqs powers and objectives, that appropriate investment clearance procedures have been followed and that approval has been granted.

Most funds managed by private equity are closed funds and exist for a period of seven to ten years. This means that the investors in the fund cannot withdraw their investment in this period. The fund will wish to %exit+ the investment within this time frame and realise its return. The parties must accordingly recognise an intention to seek an exit from the investment, within a given time scale.

Private equity providers will seek to make returns on their investment. This is usually measured by the internal rate of return. This is the annualised rate of interest worked out over the life of the fund. Because investment in private shares is risky, the returns expected by investors are high.

The usual exit for a successful investment would be a sale to a trade purchaser or floatation on a recognised stock exchange. Unsuccessful investments may end up by way of insolvency or by way of the sale of the private equity shareholding to a

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management team for a low price. Another possibility is that the investment will be restructured and transferred to other funds investors.

The Investment

The private equity provider will usually subscribe for the shares in the new company. The interests of management and the investors is usually aligned by giving management a shareholding up front, together with the possibility of increasing their shareholding after a period depending on performance. The increase in managementqs shareholding is usually structured as a performance %ratchet+ in favour of management. This will involve the equity shareholding of management increasing upon and on the basis of achieving pre-defined financial targets.

Investors usually invest by way of a combination of ordinary shares, preference shares and loan notes. Debt finance will usually form the largest part of funding. Loan notes are advantageous in that they are more tax efficient and payments can be more easily achieved.

For example, a structure might involve the private equity participant investing £900,000.00 for 90% of the shares and management investing £100,000.00 for 10% of the shares. The private equity participant may also invest additional substantial funding of, say £9,000,000.00 by way of loans or preference shares.

A bank may provide senior debt funding. This may involve a term loan and / or a working capital facility. There may also be secondary sources of debt finance known as %junior debt+. Junior debt ranks behind senior debt in the order of entitlement to repayment. Junior debt may be provided by way of %mezzanine+ (middle) finance which is so called, in terms of risk and reward between bank and equity funding.

Mezzanine or subordinated finance is usually invested as debt carrying a significantly higher rate of interest than senior debt. The higher rate compensates for the fact that they rank behind senior debt and its security. Often the mezzanine debt holders will be granted rights to subscribe for equity share capital. These rights (or warrants) attaching to mezzanine finance are known as %equity kickers+. The providers of the mezzanine finance will only exercise the warrants when the sale of the companyqs

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shares is imminent in which event, the mezzanine funder may make a large capital gains.

The structure of investment in the new company vehicle is commonly as follows:

- senior debt by the bank;
- mezzanine finance;
- high return loan notes provided by private equity;
- equity shared between the new company and the private equity provider.

The Process

Whatever the nature of the transaction, whether a buyout, start up or development capital project, the first step is to prepare a business plan. The business plan should set out details of the target company, financial accounts and projected performance. Business plans are prepared with varying degrees of sophistication, depending on the size of the transaction.

Private equity providers often appoint accountants to review business plans. They may challenge certain assumptions and may recalculate the figures from the perspective of different assumptions, outcomes or return.

Once the private equity provider has decided to invest, a term sheet is drawn up. This is an offer in principle. The offer letter of term sheet may propose an exclusivity. This means, that during a certain period, management agree not to negotiate with any third party in relation to a similar transaction.

The private equity provider will usually undertake due diligence of the company and its business. This could range from an extensive exercise to a more limited due diligence on start up and development capital investments. A large scale buyout may involve preparation of accounts, financial reports, environmental reports, insurance reports, actuarial reports and legal due diligence. The purpose is to highlight the areas of risk for private equity investors, so that they can assess the attractiveness of the proposition. When due diligence has been completed, the parties will negotiate the key legal documents.

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The exchange of contracts will represent the consummation of the deal. The investment agreement, loan and security documents and a number of other key agreements and documents are signed and become binding. The subscription monies and bank funds are advanced.

This Guide is intended as an overview and broad outline of the matters covered in it. Its purpose is to inform and raise awareness. We are happy to offer specific legal advice on particular circumstances.

This Guide should not be relied on as a substitute for comprehensive legal advice with reference to the particular circumstances.

While we have taken due care in the preparation of this publication, we do not accept legal liability as a result of any reliance placed on anything in this Guide. The reader should rely only on specific legal or taxation advice.

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