A Guide to Private Equity
BVCA mission statement

THE BVCA is the industry body and public policy advocate for private equity and venture capital in the UK, an industry that accounts for almost 60% of the European market. With a membership of over 450 members, the BVCA represents an overwhelming majority of UK-based private equity and venture capital firms and their advisers – from venture capital, through mid-market, to private equity/large buy-out houses.

For over 26 years, the BVCA’s voice has been one of authority when speaking for, or negotiating on behalf of, the UK industry to a wide range of key stakeholders: government, the European Commission and Parliament, media and statutory bodies at home, across Europe and globally. We also promote our members’ services to entrepreneurs and investors, as well as providing valuable research, training and networking opportunities to our members.

All members of the BVCA are listed in our annual ‘Directory of Members’. Other publications include reports and analysis produced by our Research team, such as the annual Performance Measurement Survey and the Report on Investment Activity. All publications are available on the BVCA website: www.bvca.co.uk
Private Equity – investing in Britain’s future

- Each year UK private equity firms provide billions of pounds to form, develop and reshape over 1,600 ambitious UK companies with high growth prospects.
- Private equity makes managers into owners, giving them the freedom, focus and finance to enable them to revitalise their companies and take them onto their next phase of growth.
- Private equity is committed, long-term and risk sharing. It provides companies with the personal experience of the investors and a stable financial base on which to make strategic decisions.
- UK private equity firms offer a wide range of sources, types and styles of private equity to meet many different needs.
- A great variety of businesses in different industry sectors benefit from private equity; including those operating in the high technology, industrial, healthcare, consumer services, financial and other sectors, and in different development stages from start-up to large established companies.
Preface

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK.

With a membership of over 450 firms, the BVCA represents the vast majority of all UK-based private equity and venture capital firms and their advisors.

“A Guide to Private Equity” is a key component in the range of BVCA publications. For further details about other BVCA publications and research see the Appendix on page 50 or the BVCA's website www.bvca.co.uk

Keith Arundale, formerly with PricewaterhouseCoopers LLP and now a university lecturer and independent adviser, suggested that the BVCA should have a guide to private equity which demystified the investment process - so he was duly asked to write it!

The first Guide was published in 1992 and since then many tens of thousands of copies have been sent out or downloaded from the BVCA's website. This new edition has again been updated by Keith, including the section on government sources of finance and new sections on specific considerations relating to venture capital and management buyout deals, term sheets and the working relationship between a private equity investor and management team. I would like to thank Keith for initiating the Guide and for his continuing help over the years.

I would also like to thank the BVCA Executive for the production of another excellent Guide.

Simon Havers
BVCA Chairman
February 2010
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An introduction to private equity

Definition

Private equity is medium to long-term finance provided in return for an equity stake in potentially high growth unquoted companies. Some commentators use the term “private equity” to refer only to the buy-out and buy-in investment sector. Some others, in Europe but not the USA, use the term “venture capital” to cover all stages, i.e. synonymous with “private equity”. In the USA “venture capital” refers only to investments in early stage and expanding companies. To avoid confusion, the term “private equity” is used throughout this Guide to describe the industry as a whole, encompassing both “venture capital” (the seed to expansion stages of investment) and management buy-outs and buy-ins.

How this Guide can help you

This Guide aims to encourage you to approach a source of private equity early in your search for finance. It explains how the private equity process works and what you need to do to improve your chances of raising it. It gives guidance on what should be included in your business plan, which is a vital tool in your search for funding. It also demonstrates the positive advantages that private equity will bring to your business.

The main sources of private equity in the UK are the private equity firms (who may invest at all stages – venture capital and buy-outs) and “business angels” (private individuals who provide smaller amounts of finance at an earlier stage than many private equity firms are able to invest). In this Guide we principally focus on private equity firms. The attributes that both private equity firms and business angels look for in potential investee companies are often very similar and so this Guide should help entrepreneurs and their advisers looking for private equity from both these sources. “Corporate venturers” which are industrial or service companies that provide funds and/or a partnering relationship to fledgling companies and may operate in the same industry sector as your business can also provide equity capital.

Throughout the 1990s the technology hype, internet boom and massive capital investment propelled the New Economy revolution, but internet mania in the late 1990s caused technology stocks to skyrocket until the bubble burst in the year 2000. There was over-optimism, too much easy money, proven ways of doing business were replaced by irrational exuberance and private and public company market valuations were driven to unsustainable levels. The mid 2000’s saw a substantial increase in the later stages of private equity transactions with large and mega buyouts fuelled by significant amounts of debt. With the onset of the credit crunch in 2007/8 and the reduction in the general availability of bank loans, and tightening of the conditions required to obtain loan finance, there is considerably less debt available for deals in the current economic environment. Banks are reluctant to lend, particularly if they have not had the experience of going through a downturn in the leveraged, high risk market before. There is however currently no shortage of private equity funds for investment in the UK. Private equity deals going forward are likely to involve much less leverage, and therefore perceived lower risk for the banks. Excellent opportunities remain open to companies seeking private equity with convincing business proposals.

Private equity firms are looking for investment opportunities where the business has proven potential for realistic growth in an expanding market, backed up by a well researched and documented business plan and an experienced management team – ideally including individuals who have started and run a successful business before. This Guide will help you to understand what private equity firms are looking for in a potential business investment and how to approach them.
What is private equity?

Private equity provides long-term, committed share capital, to help unquoted companies grow and succeed. If you are looking to start up, expand, buy into a business, buy out a division of your parent company, turnaround or revitalise a company, private equity could help you to do this. Obtaining private equity is very different from raising debt or a loan from a lender, such as a bank. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of your success or failure. Private equity is invested in exchange for a stake in your company and, as shareholders, the investors’ returns are dependent on the growth and profitability of your business.

Private equity in the UK originated in the late 18th century, when entrepreneurs found wealthy individuals to back their projects on an ad hoc basis. This informal method of financing became an industry in the late 1970s and early 1980s when a number of private equity firms were founded. Private equity is now a recognised asset class. There are over 250 active UK private equity firms, which provide several billions of pounds each year to unquoted companies.

Would my company be attractive to a private equity investor?

Many small companies are “life-style” businesses whose main purpose is to provide a good standard of living and job satisfaction for their owners. These businesses are not generally suitable for private equity investment, as they are unlikely to provide the potential financial returns to make them of interest to an external investor.

“Entrepreneurial” businesses can be distinguished from others by their aspirations and potential for growth, rather than by their current size. Such businesses are aiming to grow rapidly to a significant size. As a rule of thumb, unless a business can offer the prospect of significant turnover growth within five years, it is unlikely to be of interest to a private equity firm. Private equity investors are only interested in companies with high growth prospects, which are managed by experienced and ambitious teams who are capable of turning their business plan into reality. However, provided there is real growth potential the private equity industry is interested in all stages, from start-up to buy-out.

Some of the benefits of private equity

Private equity backed companies have been shown to grow faster than other types of companies. This is made possible by the provision of a combination of capital and experienced personal input from private equity executives, which sets it apart from other forms of finance. Private equity can help you achieve your ambitions for your company and provide a stable base for strategic decision making. The private equity firms will seek to increase a company’s value to its owners, without taking day-to-day management control. Although you may have a smaller “slice of cake”, within a few years your “slice” should be worth considerably more than the whole “cake” was to you before.

Private equity firms often work in conjunction with other providers of finance and may be able to help you to put a total funding package together for your business.

Questions to ask yourself before reading further

- Does your company have high growth prospects and are you and your team ambitious to grow your company rapidly?
- Does your company have a product or service with a competitive edge or unique selling point (USP)?
- Do you and/or your management team have relevant industry sector experience? Do you have a clear team leader and a team with complementary areas of expertise, such as management, marketing, finance, etc?
- Are you willing to sell some of your company’s shares to a private equity investor?
- If your answers are “yes”, private equity is worth considering.
Internal and external financial resources

Before looking at new external sources of finance, make sure you are making optimal use of your internal financial resources.

- Ensure that you have good cash flow forecasting systems in place
- Give customers incentives to encourage prompt payment
- Adhere to rigorous credit control procedures
- Plan payments to suppliers
- Maximise sales revenues
- Carefully control overheads
- Consider sub-contracting to reduce initial capital requirements (if appropriate)
- Assess inventory levels (if appropriate)
- Check quality control

Then think about the external options.

- Your own and your co-directors’ funds
- Friends’ or business associates’ funds
- The clearing banks – overdrafts, short or medium-term loans
- Factoring and invoice discounting
- Leasing, hire purchase
- Investment banks – medium to long-term larger loans
- Public sector grants, loans, regional assistance and advice
- Business angel finance
- Corporate venturing
- Private equity

But please don’t get the impression that private equity is a last resort after you have exhausted your own, your friends’, your business colleagues’ and your bank’s resources. There are many advantages to private equity over bank debt. Private equity firms can of course work in conjunction with the other external sources as part of an overall financing package.

Some of the alternative sources of external finance are elaborated on below for your information. These may particularly apply if you are looking for finance at the lower end of the so-called ‘equity gap’, say up to £250,000 or £500,000. The ‘equity gap’ is widely regarded as being between £250,000 and £2 million where it can be difficult to secure venture capital finance simply because of the amount of time and effort required to appraise an investment proposition by a venture capital firm. For smaller amounts of finance it is not simply worth their while, unless there will be further financing rounds required later. More recently the UK has addressed the range of financing towards the upper end of the equity gap with the Enterprise Capital Funds (ECFs) – see below – that can provide up to £2 million of financing.

Government sources of finance for SMEs and growing businesses in the UK

These include the following:

Enterprise Finance Guarantee (EFG)
The Enterprise Finance Guarantee (EFG) replaced the Small Firms Loan Guarantee Scheme (SFLG) and provides loans from £1,000 up to £1 million, repayable over 10 years, compared to an upper limit of £250,000 for the SFLG, and supports businesses with a turnover of up to £25 million, compared to £5.6 million under SFLG. The EFG can be used to support new loans, refinance existing loans or to convert part or all of an existing overdraft into a loan to release capacity to meet working capital needs. The Government will guarantee 75% of the loan. EFG is available to viable businesses that in normal circumstances would be able to secure lending from banks but who cannot secure bank lending in the current times. Most businesses in most sectors are eligible for the scheme. However, the state aid rules exclude businesses in the agriculture, coal and steel sectors.
Regional Venture Capital Funds (RVCFs)
The Regional Venture Capital Funds (RVCFs) were set up to address small to medium enterprises (SMEs) seeking relatively small-scale investment of up to £500,000 (subsequently raised to £660,000). The RVCFs operate on a regional basis with the objective of testing whether returns can be earned from having regionally focused investment teams targeting equity gap investment. The funds cover the North East, North West, London, Yorkshire and the Humber, South East and South West, East Midlands, West Midlands and East of England regions of the UK. The last RVCF ceased making new investments in December 2008 but the funds are still able to support existing portfolio businesses. The Enterprise Capital Fund (ECF) programme has now superseded the RVCFs.

Enterprise Capital Funds (ECFs)
Enterprise Capital Funds (ECFs) are a UK government initiative aimed at bridging the equity gap by improving access to growth capital for small and medium-sized enterprises by applying a modified US Small Business Investment Company (SBIC) model to the UK, a difference being that with the UK scheme the government has downside protection with a priority return of 4.5% per annum plus a minor profit share.

ECFs are privately managed and use a limited partnership model with two variants:
- a professional FSA authorised fund manager who acts on behalf of passive investors
- an active investor model (e.g. business angels) who invest and manage their own funds through ECFs (maybe without FSA authorisation).

There are now eight ECFs in operation and a further fund was recently awarded ECF status. Responsibility for the management of ECFs was transferred to Capital for Enterprise Limited (CIEL) in 2008.

ECFs receive their funding from the UK government and private sources. There is no maximum fund size for an ECF, but the government will commit no more than £25 million to a single fund or no more than twice the private capital, whichever is lower.

Equity investments of up to £2 million per deal can be made but to avoid the problems of dilution experienced by many early stage investors ECFs are allowed to invest more than £2 million in a single company if not to do so as part of a subsequent funding round would dilute their exiting stake in the company.

To access support from an Enterprise Capital Fund contact your local Business Link or contact the relevant fund manager. The eight currently operational ECFs are:

- IQ Capital Fund
- 21st Century Sustainable Technology Growth Fund
- The Seraphim Capital Fund
- The Amadeus Enterprise Fund
- The Catapult Growth Fund
- Dawn Capital ECF
- Oxford Technology Management ECF
- MMC Venture Managers.

CIEL also has responsibility for the Enterprise Finance Guarantee scheme (above) and includes a number of funds in its portfolio, additional to the ECFs. These include:

- Capital for Enterprise Fund (CFE) (mezzanine debt and equity support for established growth businesses across the UK)
- Aspire Fund (targeting women led businesses across the UK)
- Bridges Social Entrepreneurs Fund and the Bridges Sustainable Property Fund (specific strategies to achieve a positive social and/or environmental impact).
- Early Growth Funds (below).
Early Growth Funds

Early growth funds are regional and national funds provided through the Small Business Service (SBS). They can provide up to £100,000 for innovative and knowledge-intensive start-up and early-stage businesses as well as other growth businesses. In most cases they must be matched by at least the same amount of private sector investment.

Grants for Business Investment (GBI)

Grants for Business Investment (GBI) (formerly known as Selective Finance for Investment in England or SFIE grants) are discretionary grants available from Government through the Department for Business, Innovation & Skills (BIS) to support businesses with investment projects which will increase productivity, skills and employment in deprived areas in England. The GBI grants are managed by the Regional Development Agencies. SFIE itself replaced the former Regional Selective Assistance Scheme. The scheme is designed for businesses that are looking at the possibility of investing in an area of high deprivation but need financial help to go ahead. It is awarded as a percentage of eligible project expenditure and is provided as a grant towards capital costs such as fixed assets, land, property and machinery. Grants can be used for start-ups, modernising through introducing technological improvements, expanding an existing business, or taking a new product /service/ process from the development stage to production. The amount of support you will be awarded will depend on the specific needs of your project, the quality of the project and its impact on productivity and skills. The project must create new jobs or safeguard existing employment if seeking support of £100,000 or more.

University Challenge Seed Fund Scheme

The aim of the Government’s University Challenge Seed Fund Scheme is to fill a funding gap in the UK in the provision of finance for bringing university research initiatives in science and engineering to the point where their commercial viability can be demonstrated. Certain charities and the government have contributed around £60 million to the scheme. These funds are divided into 19 University Challenge Seed Funds that have been donated to individual universities or consortia and each one of these has to provide 25% of the total fund from its own resources. If you are looking into the commercialisation of research at a UK university which is in receipt of a fund, contact your university administration to enquire about the application process. Follow-on finance may be provided by business angels, corporate venturers and private equity firms.

Grants for Research & Development

Grants for Research & Development (previously the DTI ‘Smart’ scheme) aim to help start-ups and SMEs carry out research and development work on technologically innovative products and processes. They are administered by the nine English Regional Development Agencies. There are four different types of research and development project that a grant can be awarded for with grants varying from up to a maximum of £20,000 to up to a maximum of £500,000.

UK Innovation Investment Fund (UKIIF)

The Government is in the process of setting up a venture capital-based £150 million Innovation Investment Fund as a vehicle to encourage growing small businesses, start-ups and spin-outs in high-tech businesses. The new scheme will invest alongside private sector investment on a pari-passu basis; it is the Government’s belief that this could leverage enough private investment to build a fund of up to £1 billion over the next 10 years.

Two fund of funds managers have recently been appointed to operate the scheme with responsibility for ensuring that investment is directed at companies with “strong survival and growth prospects”. Individual fund managers will be told to target the “sectors of the future” – businesses in the life sciences, low-carbon, digital and advanced manufacturing businesses, in the search for worthwhile investments. It is hoped that the fund of funds approach will avoid competing with other public sector investment initiatives such as the Enterprise Capital Funds.
Enterprise Investment Scheme
The Enterprise Investment Scheme which was set up by the UK government to replace the Business Expansion Scheme (BES) and to encourage business angels to invest in certain types of smaller unquoted UK companies. If a company meets the EIS criteria (See http://www.hmrc.gov.uk/eis/), it may be more attractive to business angels, as tax incentives are available on their investments. Under the Enterprise Investment Scheme, individuals not previously connected with a qualifying unlisted trading company (including shares traded on the Alternative Investment Market (AIM)) can make investments of up to £500,000 in a single tax year and receive tax relief at 20 % on new subscriptions for ordinary shares in the company, and relief from CGT on disposal, provided the investment is held for three years.

Venture Capital Trusts (VCTs)
Venture Capital Trusts (VCTs) which are quoted vehicles to encourage investment in smaller unlisted (unquoted and AIM quoted) UK companies. Investors receive 30% income tax relief on VCT investment on a maximum investment amount of £200,000 in each tax year provided the investment is held for five years. Shares in VCTs acquired within the annual limit are also exempt from capital gains tax on disposal at any time.

For further information on the above UK government grants and others available visit the website of the Business Links at www.businesslink.gov.uk. In addition to providing advice on the various grants available to SMEs and growth companies the Business Links provide advice, help and an entry point to the various schemes run by the Department for Business, Innovation and Skills (BIS). New businesses (particularly those using new technology) can get help with premises and management from the various Business Incubation Centres in the UK or from one of the UK Science Parks. You may also be eligible for EU grants if you are in an innovative business sector or are planning to operate in a deprived area of the UK or a region zoned for regeneration. Apart from Business Links your local Chamber of Commerce and town hall should have lists of grants and available property.

Business angels
Business angels are private investors who invest directly in private companies in return for an equity stake and perhaps a seat on the company’s board. Research has shown that business angels generally invest smaller amounts of private equity in earlier stage companies compared with private equity firms. They typically invest between £20,000 and £200,000 at the seed, start-up and early stages of company development, or they may invest more than this as members of syndicates, possibly up to £1.5 million. Business angels will usually want a “hands-on” role with the company that they invest in, maybe as an adviser and/or a non-executive director or they may even take on an executive role. Many companies find business angels through informal contacts, but for others, finding a business angel may be more difficult, as the details of individual business angels are not always available. The British Business Angels Association (BBAA) lists its members on its website (www.bbaa.org.uk) so this is a good place to start to help you find business angel investor networks in the UK.

Corporate venturing
Corporate venturing has developed quite rapidly, albeit sporadically, in recent years but still represents only a small fraction when compared to private equity investment activity. Direct corporate venturing occurs where a corporation takes a direct minority stake in an unquoted company. Indirect corporate venturing is where a corporation invests in private equity funds managed by an independent private equity firm. Corporate venturers raise their funds from their parent organisations and/or from external sources.
**Investment forums and networking organisations**

In addition to business angel networks you can also find angel investors (and venture capitalists) at various investment forums that are organized in the UK. Typically at these events entrepreneurs seeking capital get to present their propositions to an audience of VCs, angels, corporate investors and advisors. Presenters have around 10 to 15 minutes to make their presentation (a sort of extended ‘elevator pitch’). Depending on the prestige and size of the event there may be a selection process to decide which companies get to make presentations and payment may or may not be required. Some of these events are put on by the larger conference organizers, others are organized by universities and business schools and networking clubs. Usually, in addition to the company presentations, there will be one or more plenary sessions from invited guest speakers, including successful entrepreneurs on topical issues.

Do speak to friends, business contacts and advisers as well as your local Business Link. Do remember there are many misconceptions about the various sources of finance, so obtain as much information as possible to ensure that you can realistically assess the most suitable finance for your needs and your company’s success.

**Well-known private equity backed companies**

Agent Provocateur  
Alliance Boots  
Autonomy  
Birds Eye Iglo  
Cambridge Silicon Radio  
CenterParcs  
Earls Court & Olympia  
Findus Group (Foodvest)  
Fitness First  
Jimmy Choo  
Merlin Entertainments Group  
Moto  
National Car Parks  
New Look  
Odeon & UCI Cinemas  
Phones4U  
Pizza Express/Zizzi/Ask – Gondola Group  
Plastic Logic  
Poundland  
Pret A Manger  
The AA/Saga  
Travelex  
Travelodge  
UCI Cinemas/Odeon Cinemas  
Weetabix  
West Cornwall Pasty Co.

**The advantages of private equity over senior debt**

A provider of debt (generally a bank) is rewarded by interest and capital repayment of the loan and it is usually secured either on business assets or your own personal assets, such as your home. As a last resort, if the company defaults on its repayments, the lender can put your business into receivership, which may lead to the liquidation of any assets. A bank may in extreme circumstances even bankrupt you, if you have given personal guarantees. Debt which is secured in this way and which has a higher priority for repayment than that of general unsecured creditors is referred to as “senior debt”.
By contrast, private equity is not secured on any assets although part of the non-equity funding package provided by the private equity firm may seek some security. The private equity firm, therefore, often faces the risk of failure just like the other shareholders. The private equity firm is an equity business partner and is rewarded by the company’s success, generally achieving its principal return through realising a capital gain through an “exit” which may include:

- Selling their shares back to the management
- Selling the shares to another investor (such as another private equity firm)
- A trade sale (the sale of a company shares to another company)
- The company achieving a stock market listing.

Although private equity is generally provided as part of a financing package, to simplify comparison we compare private equity with senior debt.

### Private equity compared to senior debt

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<th>Medium to long-term.</th>
<th>Short to long-term.</th>
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<td>Committed until “exit”.</td>
<td>Not likely to be committed if the safety of the loan is threatened. Overdrafts are payable on demand; loan facilities can be payable on demand if the covenants are not met.</td>
</tr>
<tr>
<td>Provides a solid, flexible, capital base to meet your future growth and development plans.</td>
<td>A useful source of finance if the debt to equity ratio is conservatively balanced and the company has good cash flow.</td>
</tr>
<tr>
<td>Good for cash flow, as capital repayment, dividend and interest costs (if relevant) are tailored to the company’s needs and to what it can afford.</td>
<td>Requires regular good cash flow to service interest and capital repayments.</td>
</tr>
<tr>
<td>The returns to the private equity investor depend on the business’ growth and success. The more successful the company is, the better the returns all investors will receive.</td>
<td>Depends on the company continuing to service its interest costs and to maintain the value of the assets on which the debt is secured.</td>
</tr>
<tr>
<td>If the business fails, private equity investors will rank alongside other shareholders, after the banks and other lenders, and stand to lose their investment.</td>
<td>If the business fails, the lender generally has first call on the company’s assets.</td>
</tr>
<tr>
<td>If the business runs into difficulties, the private equity firm will work hard to ensure that the company is turned around.</td>
<td>If the business appears likely to fail, the lender could put your business into receivership in order to safeguard its loan, and could make you personally bankrupt if personal guarantees have been given.</td>
</tr>
<tr>
<td>A true business partner, sharing in your risks and rewards, with practical advice and expertise (as required) to assist your business success.</td>
<td>Assistance available varies considerably.</td>
</tr>
</tbody>
</table>
Sources of private equity

There is a wide range of types and styles of private equity available in the UK. The primary sources are private equity firms who may provide finance at all investment stages and business angels who focus on the start-up and early stages. In targeting prospective sources of finance and business partners, as in any field, it works best if you know something about how they operate, their structure, and their preferences.

Private equity firms

Private equity firms usually look to retain their investment for between three and seven years or more. They have a range of investment preferences and/or type of financing required. It is important that you only approach those private equity firms whose preferences match your requirements.

Where do private equity firms obtain the money to invest in my business?

Just as you and your management team are competing for finance, so are private equity firms, as they raise their funds from a number of different sources. To obtain their funds, private equity firms have to demonstrate a good track record and the prospect of producing returns greater than can be achieved through fixed interest or quoted equity investments. Most UK private equity firms raise their funds for investment from external sources, mainly institutional investors, such as pension funds and insurance companies, and are known as independents. Private equity firms that obtain their funds mainly from their parent organisation are known as captives. Increasingly, former captives now raise funds from external sources as well and are known as semi-captives. These different terms for private equity firms now overlap considerably and so are increasingly rarely used.

How may the source of a private equity firm’s money affect me?

Private equity firms’ investment preferences may be affected by the source of their funds. Many funds raised from external sources are structured as limited partnerships and usually have a fixed life of 10 years. Within this period the funds invest the money committed to them and by the end of the 10 years they will have had to return the investors’ original money, plus any additional returns made. This generally requires the investments to be sold, or to be in the form of quoted shares, before the end of the fund. Some funds are structured as quoted private equity investment trusts, listed on the London Stock Exchange and other major European stock markets (see www.lpeq.com for more information), and as they have no fixed lifespan, they may be able to offer companies a longer investment horizon.

Venture Capital Trusts (VCTs) (see above) are quoted vehicles that aim to encourage investment in smaller unlisted (unquoted and AIM quoted) UK companies by offering private investors tax incentives in return for a five-year investment commitment. If funds are obtained from a VCT, there may be some restrictions regarding the company’s future development within the first few years.
**How do I select the right private equity firm?**

Some private equity firms manage a range of funds (as described above) including investment trusts, limited partnerships and venture capital trusts, and the firms’ investment preferences are listed in the BVCA Directory of members. A fully searchable version of the Directory is available to those seeking private equity investment on www.bvca.co.uk. It lists private equity firms, their investment preferences and contact details. It also lists financial organisations, such as mezzanine firms, fund of funds managers and professional advisers, such as accountants and lawyers, who are experienced in the private equity field. Your advisers may be able to introduce you to their private equity contacts and assist you in selecting the right private equity firm. If they do not have suitable contacts or cannot assist you in seeking private equity, obtain a copy of the Directory and refer to the professional advisers listed in the “Associate Members” section.

As far as a company looking to raise private equity is concerned, only those whose investment preferences match your requirements should be approached. Private equity firms appreciate it when they are obviously targeted after careful consideration.

You may find it interesting to obtain a copy of the BVCA’s Report on Investment Activity which analyses the aggregate annual investment activity of the UK private equity industry. It looks at the number of companies backed and the amounts they received by stage, industry sector and region.

The next chapter will take you through the selection process in more detail.
Selecting a private equity firm

Firstly, decide whether or not to hire an adviser (see the section on ‘The role of professional advisers’).

**Targeting**

The most effective way of raising private equity is to select just a few private equity firms to target with your business proposition. The key considerations should be to assess:

1. The **stage** of your company’s development or the **type** of private equity investment required.
2. The **industry** sector in which your business operates.
3. The **amount** of finance your company needs.
4. The **geographical location** of your business operations.

You should select only those private equity firms whose investment preferences match these attributes. The BVCA Directory of members specifies their investment preferences and contact details. It also includes the names of some of the companies in which they have invested.

**1. Stage/type of investment**

The terms that most private equity firms use to define the stage of a company’s development are determined by the purpose for which the financing is required.

**Seed**

To allow a business concept to be developed, perhaps involving the production of a business plan, prototypes and additional research, prior to bringing a product to market and commencing large-scale manufacturing.

Only a few seed financings are undertaken each year by private equity firms. Many seed financings are too small and require too much hands-on support from the private equity firm to make them economically viable as investments. There are, however, some specialist private equity firms which are worth approaching, subject to the company meeting their other investment preferences. Business angel capital should also be considered, as with a business angel on a company’s board, it may be more attractive to private equity firms when later stage funds are required.

**Start-up**

To develop the company’s products and fund their initial marketing. Companies may be in the process of being set up or may have been trading for a short time, but not have sold their product commercially.

Although many start-ups are typically smaller companies, there is an increasing number of multi-million pound start-ups. Several BVCA members will consider high quality and generally larger start-up propositions as well as investing in the later stages. However, there are those who specialise in the start-up stage, subject to the company seeking investment meeting the firm’s other investment preferences.

**Other early stage**

To initiate commercial manufacturing and sales in companies that have completed the product development stage, but may not yet be generating profits.

This is a stage that has been attracting an increasing amount of private equity over the past few years.

**Expansion**

To grow and expand an established company. For example, to finance increased production capacity, product development, marketing and to provide additional working capital. Also known as “development” or “growth” capital.
Management buy-out (MBO)
To enable the current operating management and investors to acquire or to purchase a significant shareholding in the product line or business they manage. MBOs range from the acquisition of relatively small formerly family owned businesses to well over £100 million buy-outs. The amounts concerned tend to be larger than other types of financing, as they involve the acquisition of an entire business.

Management buy-in (MBI)
To enable a manager or group of managers from outside a company to buy into it.

Buy-in management buy-out (BIMBO)
To enable a company’s management to acquire the business they manage with the assistance of some incoming management.

Institutional buy-out (IBO)
To enable a private equity firm to acquire a company, following which the incumbent and/or incoming management will be given or acquire a stake in the business.

This is a relatively new term and is an increasingly used method of buy-out. It is a method often preferred by vendors, as it reduces the number of parties with whom they have to negotiate.

Secondary purchase
When a private equity firm acquires existing shares in a company from another private equity firm or from another shareholder or shareholders.

Replacement equity
To allow existing non-private equity investors to buy back or redeem part, or all, of another investor’s shareholding.

Rescue/turnaround
To finance a company in difficulties or to rescue it from receivership.

Refinancing bank debt
To reduce a company’s level of gearing.

Bridge financing
Short-term private equity funding provided to a company generally planning to float within a year.

For recent information on the actual amounts invested at each stage of investment, see the “BVCA Report on Investment Activity”, available at: http://www.bvca.co.uk/Research

2. Industry sector
Most private equity firms will consider investing in a range of industry sectors – if your requirements meet their other investment preferences. Some firms specialise in specific industry sectors, such as biotechnology, computer related, clean tech and other technology areas. Others may actively avoid sectors such as property or film production.

3. Amount of investment
The majority of UK private equity firms’ financings each year are for amounts of well over £100,000 per company. There are, however, a number of private equity firms who will consider investing amounts of private equity under £100,000 and these tend to include specialist and regionally orientated firms. Companies initially seeking smaller amounts of private equity are more attractive to private equity firms if there is an opportunity for further rounds of private equity investment later on.
The process for investment is similar, whether the amount of capital required is £100,000 or £10 million or more, in terms of the amount of time and effort private equity firms have to spend in appraising the business proposal prior to investment. This makes the medium to larger-sized investments more attractive for private equity investment, as the total size of the return (rather than the percentage) is likely to be greater than for smaller investments, and should more easily cover the initial appraisal costs.

Business angels are perhaps the largest source of smaller amounts of equity finance, often investing amounts ranging between £20,000 and £200,000 in early stage and smaller expanding companies.

4. Geographical location

Several private equity firms have offices in the UK regions. Some regions are better served with more local private equity firms than others, but there are also many firms, particularly in London, who look to invest UK-wide.
The business plan

A business plan’s main purpose when raising finance is to market your business proposal. It should show potential investors that if they invest in your business, you and your team will give them a unique opportunity to participate in making an excellent return.

A business plan should be considered an essential document for owners and management to formally assess market needs and the competition; review the business’ strengths and weaknesses; and to identify its critical success factors and what must be done to achieve profitable growth. It can be used to consider and reorganise internal financing and to agree and set targets for you and your management team. It should be reviewed regularly.

The company’s management should prepare the business plan. Its production frequently takes far longer than the management expects. The owner or the managing director of the business should be the one who takes responsibility for its production, but it should be “owned” and accepted by the management team as a whole and be seen to set challenging but achievable goals that they are committed to meeting. It should emphasise why you are convinced that the business will be successful and convey what is so unique about it. Private equity investors will want to learn what you and your management are planning to do, not see how well others can write for you.

Professional advisers can provide a vital role in critically reviewing the draft plan, acting as “devil’s advocate” and helping to give the plan the appropriate focus. Several of the larger accounting firms publish their own detailed booklets on how to prepare business plans. However, it is you who must write the plan as private equity firms generally prefer management driven plans, such as are illustrated in this chapter.

Essential areas to cover in your business plan

Many businesses fail because their plans have not been properly thought out, written down and developed. A business plan should be prepared to a high standard and be verifiable. A business plan covering the following areas should be prepared before a private equity firm is approached.

Executive Summary

This is the most important section and is often best written last. It summarises your business plan and is placed at the front of the document. It is vital to give this summary significant thought and time, as it may well determine the amount of consideration the private equity investor will give to your detailed proposal. It should be clearly written and powerfully persuasive, yet balance “sales talk” with realism in order to be convincing.

It needs to be convincing in conveying your company’s growth and profit potential and management’s prior relevant experience. It needs to clearly encapsulate your company’s USP (i.e. its unique selling point – why people should buy your product or service as distinct from your competitors).

The summary should be limited to no more than two to three pages (i.e. around 1,000 to 1,500 words) and include the key elements from all the points below:

1. The market
2. The product or service
3. The management team
4. Business operations
5. Financial projections
6. Amount and use of finance required and exit opportunities
Other aspects that should be included in the Executive Summary are your company’s “mission statement” – a few sentences encapsulating what the business does for what type of clients, the management’s aims for the company and what gives it its competitive edge. The mission statement should combine the current situation with your aspirations. You should also explain the current legal status of your business in this section. You should include an overall “SWOT” (strengths, weaknesses, opportunities and threats) analysis that summarises the key strengths of your proposition and its weaknesses and the opportunities for your business in the marketplace and its competitive threats.

1. The market

You need to convince the private equity firm that there is a real commercial opportunity for the business and its products and services. This requires a careful analysis of the market potential for your products or services and how you plan to develop and penetrate the market.

Market analysis

This section of the business plan will be scrutinised carefully; market analysis should therefore be as specific as possible, focusing on believable, verifiable data. Include under market research a thorough analysis of your company’s industry and potential customers. Include data on the size of the market, growth rates, recent technical advances, Government regulations and trends – is the market as a whole developing, growing, mature, or declining? Include details on the number of potential customers, the purchase rate per customer, and a profile of the typical decision-maker who will decide whether to purchase your product or service. This information drives the sales forecast and pricing strategy in your plan. Finally, comment on the percentage of the target market your company plans to capture, with justification in the marketing section of the plan.

Marketing plan

The primary purpose of the marketing section of the business plan is for you to convince the private equity firm that the market can be developed and penetrated. The sales projections that you make will drive the rest of the business plan by estimating the rate of growth of operations and the financing required. Explain your plans for the development of the business and how you are going to achieve those goals. Avoid using generalised extrapolations from overall market statistics.

The plan should include an outline of plans for pricing, distribution channels and promotion.

Pricing

How you plan to price a product or service provides an investor with insight for evaluating your overall strategy. Explain the key components of the pricing decision – i.e. image, competitive issues, gross margins, and the discount structure for each distribution channel. Pricing strategy should also involve consideration of future product releases.

Distribution channels

If you are a manufacturer, your business plan should clearly identify the distribution channels that will get the product to the end-user. If you are a service provider, the distribution channels are not as important as are the means of promotion. Distribution options for a manufacturer may include:

- Distributors
- Wholesalers
- Retailers (including on-line)
- Direct sales - such as mail order and ordering over the web, direct contact through salespeople and telemarketing.
- Original Equipment Manufacturers (OEM), integration of the product into other manufacturers’ products.

Each of these methods has its own advantages, disadvantages and financial impact, and these should be clarified in the business plan. For example, assume your company decides to use direct sales because of the expertise required in selling the product. A direct salesforce increases control,
but it requires a significant investment. An investor will look to your expertise as a salesperson, or to the plans to hire, train and compensate an expert salesforce. If more than one distribution channel is used, they should all be compatible. For example, using both direct sales and wholesalers can create channel conflict if not managed well.

Fully explain the reasons for selecting these distribution approaches and the financial benefits they will provide. The explanation should include a schedule of projected prices, with appropriate discounts and commissions as part of the projected sales estimates. These estimates of profit margin and pricing policy will provide support for the investment decision.

**Promotion**

The marketing promotion section of the business plan should include plans for product sheets, potential advertising plans, internet strategy, trade show schedules, and any other promotional materials. The private equity firm must be convinced that the company has the expertise to move the product to market. A well-thought-out promotional approach will help to set your business plan apart from your competitors.

It is important to explain the thought process behind the selected sources of promotion and the reasons for those not selected.

**Competition**

A discussion of the competition is an essential part of the business plan. Every product or service has competition; even if your company is first-to-market, you must explain how the market’s need is currently being met and how the new product will compete against the existing solution. The investor will be looking to see how and why your company can beat the competition. The business plan should analyse the competition (who are they, how many are there, what proportion of the market do they account for?). Give their strengths and weaknesses relative to your product.

Attempt to anticipate likely competitive responses to your product. Include, if possible, a direct product comparison based on price, quality, warranties, product updates, features, distribution strategies, and other means of comparison. Document the sources used in this analysis.

All the aspects included in the market section of your business plan must be rigorously supported by as much verifiable evidence as possible. In addition to carrying out market research and discussions with your management team, customers and potential customers, you may need input from outside marketing consultants.

2. The product or service

Explain the company’s product or service in plain English. If the product or service is technically orientated this is essential, as it has to be readily understood by non-specialists.

Emphasise the product or service’s competitive edge or USP. For example, is it:

- A new product?
- Available at a lower price?
- Of higher quality?
- Of greater durability?
- Faster to operate?
- Smaller in size?
- Easier to maintain?
- Offering additional support products or services?

With technology companies where the product or service is new, there has to be a clear “world class” opportunity to balance the higher risks involved. Address whether it is vulnerable to technological advances made elsewhere.
• If relevant, explain what legal protection you have on the product, such as patents attained, pending or required. Assess the impact of legal protection on the marketability of the product.
• You also need to cover of course the price and cost of the product or service.
• If the product is still under development the plan should list all the major achievements to date as well as remaining milestones to demonstrate how you have tackled various hurdles and that you are aware of remaining hurdles and how to surmount them. Specific mention should be made of the results of alpha (internal) and beta (external) product testing.
• Single product companies can be a concern for investors. It is beneficial to include ideas and plans for a "second generation" product or even other viable products or services to demonstrate the opportunities for business growth.

3. The management team

Private equity firms invest in people – people who have run or who are likely to run successful operations. Potential investors will look closely at you and the members of your management team. This section of the plan should introduce the management team and what you all bring to the business. Include your experience, and success, in running businesses before and how you have learned from not so successful businesses. You need to demonstrate that the company has the quality of management to be able to turn the business plan into reality.

The senior management team ideally should be experienced in complementary areas, such as management strategy, finance and marketing and their roles should be specified. The special abilities each member brings to the venture should be explained. This is particularly the case with technology companies where it will be the combination of technological and business skills that will be important to the backers. If some members have particular flair and dynamism, this needs to be balanced by those who can ensure this occurs in a controlled environment.

A concise curriculum vitae should be included for each team member, highlighting their previous track records in running, or being involved with successful businesses.
• Identify the current and potential skills’ gaps and explain how you aim to fill them. Private equity firms will sometimes assist in locating experienced managers where an important post is unfilled – provided they are convinced about the other aspects of your plan.
• Explain what controls and performance measures exist for management, employees and others.
• List your auditors and other advisers.
• The appointment of a non-executive director (NED) should be seriously considered. Many surveys have shown that good NEDs add significant value to the companies with which they are involved. Many private equity firms at the time of their investment will wish to appoint one of their own executives or an independent expert to your board as an NED. Most private equity executives have previously worked in industry or in finance and all will have a wide experience of companies going through a rapid period of growth and development.

The BVCA’s 2007 Economic Impact Survey (available at www.bvca.co.uk/Research) reveals that generally over three-quarters of the private equity backed companies feel that the private equity firms make a major contribution other than the provision of money. Contributions cited by private equity backed companies include private equity firms being used to provide financial advice, guidance on strategic matters, for management recruitment purposes as well as for their contacts and market information.

4. Business operations

This section of the business plan should explain how your business operates, including how you make the products or provide the service. It should also outline your company’s approach to research and development. Include details on the location and size of your facilities. Factors such as the availability of labour, accessibility of materials, proximity to distribution channels, and the availability of Government grants and tax incentives should be mentioned. Describe the equipment used or planned.
is required in response to production demands, include plans for financing. If your company needs international distribution, mention whether the operations facility will provide adequate support. If work will be outsourced to subcontractors – eliminating the need to expand facilities – state that too. The investor will be looking to see if there are inconsistencies in your business plan.

If a prototype has not been developed or there is other uncertainty concerning production, include a budget and timetable for product development. The private equity firm will be looking to see how flexible and efficient the facility plans are. The private equity firm will also ask such questions as:

- If sales projections predict a growth rate of 25% per year, for example, does the current site allow for expansion?
- Are there suppliers who can provide the materials required?
- Is there an educated work force in the area?

These and any other operational factors that might be important to the investor should be included.

5. Financial projections

Developing a detailed set of financial projections will help to demonstrate to the investor that you have properly thought out the financial implications of your company’s growth plans. Private equity firms will use these projections to determine if:

- Your company offers enough growth potential to deliver the type of return on investment that the investor is seeking.
- The projections are realistic enough to give the company a reasonable chance of attaining them.

Investors will expect to see a full set of cohesive financial statements – including a balance sheet, income statement and cash-flow statement, for a period of three to five years. It is usual to show monthly income and cash flow statements until the breakeven point is reached followed by yearly data for the remaining time frame. Ensure that these are easy to update and adjust. Do include notes that explain the major assumptions used to develop the revenue and expense items and explain the research you have undertaken to support these assumptions.

Preparation of the projections

- Realistically assess sales, costs (both fixed and variable), cash flow and working capital. Assess your present and prospective future margins in detail, bearing in mind the potential impact of competition.
- Assess the value attributed to the company’s net tangible assets.
- State the level of gearing (i.e. debt to shareholders’ funds ratio). State how much debt is secured on what assets and the current value of those assets.
- Include all costs associated with the business. Remember to split sales costs (e.g. communications to potential and current customers) and marketing costs (e.g. research into potential sales areas). What are the sale prices or fee charging structures?
- Provide budgets for each area of your company’s activities. What are you doing to ensure that you and your management keep within these or improve on these budgets?
- Present different scenarios for the financial projections of sales, costs and cash flow for both the short and long term. Ask “what if?” questions to ensure that key factors and their impact on the financings required are carefully and realistically assessed. For example, what if sales decline by 20%, or supplier costs increase by 30%, or both? How does this impact on the profit and cash flow projections?
- If it is envisioned that more than one round of financing will be required (often the case with technology-based businesses in particular), identify the likely timing and any associated progress “milestones” which need to be achieved.
- Keep the plan feasible. Avoid being over optimistic. Highlight challenges and show how they will be met.

You might wish to consider using an external accountant to review the financial projections and act as “devil’s advocate” for this part of the plan.
6. Amount and use of finance required and exit opportunities

You need to determine how much finance is required by your venture as detailed in your cash flow projections. This needs to be the total financing requirement, including fixed asset and working capital requirements and the costs of doing the deal. Ascertain how much of this can be taken as debt as this is a cheaper form of finance than equity. This will depend on the assets in the business that can be used to secure the debt, the cash flow being generated to pay interest and repay amounts borrowed and the level of interest cover, i.e. the safety margin that the business has in terms of being able to meet its banking interest obligations from its profits. Then determine how much management can invest in the venture from your own resources and those of family and friends. Include any government sources of finance available to you also. The balance is then the amount you are seeking from the venture capitalist.

In this section of the business plan you need to:

- State how much finance is required by your business and from what sources (i.e. management, private equity firm, banks and others) and explain for what it will be used.
- Include an implementation schedule, including, for example, capital expenditure, orders and production timetables.
- Consider how the private equity investors will make a return, i.e. realise their investment. This may only need outlining if you are considering floating your company on a stock exchange within the next few years. However, it is important that the options are considered and discussed with your investors.

The presentation of your business plan

Bear the following points in mind when you are writing your business plan.

Readability

Make the plan readable. Avoid jargon and general position statements. Use plain English – especially if you are explaining technical details. Aim it at nonspecialists, emphasising its financial viability. Avoid including unnecessary detail and prevent the plan from becoming too lengthy. Put detail into appendices. Ask someone outside the company to check it for clarity and “readability”. Remember that the readers targeted will be potential investors. They will need to be convinced of the company’s commercial viability and competitive edge and will be particularly looking to see the potential for making a good return.

Length

The length of your business plan depends on individual circumstances. It should be long enough to cover the subject adequately and short enough to maintain interest. For a multi-million pound technology company with sophisticated research and manufacturing elements, the business plan could be well over 50 pages including appendices. By contrast, a proposal for £200,000 to develop an existing product may be too long at 10 pages. It is probably best to err on the side of brevity – for if investors are interested they can always call you to ask for additional information. Unless your business requires several million pounds of private equity and is highly complex, we would recommend the business plan should be no longer than 15 pages.

Appearance

Use graphs and charts to illustrate and simplify complicated information. Use titles and sub-titles to divide different subject matters. Ensure it is neatly typed or printed without spelling, typing or grammar mistakes – these have a disproportionately negative impact. Yet avoid very expensive documentation, as this might suggest unnecessary waste and extravagance.
**Things to avoid!**

On a lighter note, the following signs of extravagance and non-productive company expenditure are likely to discourage a private equity firm from investing and so are best avoided:

- Flashy, expensive cars
- Company yacht/plane
- Personalised number plate
- Carpets woven with the company logo
- Company flag pole
- Fountain in the forecourt
- “International” in your name (unless you are!)
- Fish tank in the board room
- Founder’s statue in reception.

The above signs are common signs of a company about to go ‘bust’. As one company liquidator commented: ‘the common threads I look for in any administration or liquidation are as you drive up to the premises there’s a flagpole, when I’m in reception, a fish tank and in between typically I walk past a lot of number plates that are personalized so if they’ve got all three, there’s no hope of recovery’.
The investment process

The investment process, from reviewing the business plan to actually investing in a proposition, can take a private equity firm anything from one month to one year but typically it takes between three and six months. There are always exceptions to the rule and deals can be done in extremely short time frames. Much depends on the quality of information provided and made available to the private equity firm.

Reaching your audience

When you have fully prepared the business plan and received input from your professional adviser, the next step is to arrange for it to be reviewed by a few private equity firms. You should select only those private equity firms whose investment preferences match the investment stage, industry, location of, and amount of equity financing required by your business proposition.

Confidentiality

If you wish to use a confidentiality letter, an example of one can be obtained from the BVCA’s website. The general terms of this letter have been agreed by BVCA members and with your lawyer’s advice you can adapt it to meet your own requirements. You can then ask the private equity investor to sign it, before being sent the full business plan. We would recommend, however, that you only ask for a confidentiality letter when the potential investor has received your Executive Summary and has shown an interest in giving your proposal detailed consideration.

How quickly should I receive a response?

Generally you should receive an initial indication from the private equity firms that receive your business plan within a week or so. This will either be a prompt “no”, a request for further information, or a request for a meeting. If you receive a “no”, try to find out the reasons as you may have to consider incorporating revisions into your business plan, changing/strengthening the management team or carrying out further market research before approaching other potential investors.

How do private equity firms evaluate a business plan?

They will consider several principal aspects:

• Is the product or service commercially viable?
• Does the company have potential for sustained growth?
• Does management have the ability to exploit this potential and control the company through the growth phases?
• Does the possible reward justify the risk?
• Does the potential financial return on the investment meet their investment criteria?
Presenting your business plan and negotiations

If a private equity firm is interested in proceeding further, you will need to ensure that the key members of the management team are able to present the business plan convincingly and demonstrate a thorough knowledge and understanding of all aspects of the business, its market, operation and prospects.

Assuming a satisfactory outcome of the meeting and further enquiries, the private equity firm will commence discussions regarding the terms of the deal with you. The first step will be to establish the value of your business.

Valuing the business

There is no right or wrong way of valuing a business. There are several ways in which it can be done.

Calculate the value of the company in comparison with the values of similar companies quoted on the stock market.

The key to this calculation is to establish an appropriate price/earnings (P/E) ratio for your company. The P/E ratio is the multiple of profits after tax attributed to a company to establish its capital value. P/E ratios for quoted companies are listed in the back pages of the Financial Times, and are calculated by dividing the current share price by historic post-tax earnings per share. Quoted companies’ P/E ratios will vary according to industry sector (its popularity and prospects), company size, investors’ sentiments towards it, its management and its prospects, and can also be affected by the timing of year-end results announcements.

The private equity investment process

<table>
<thead>
<tr>
<th>Stage</th>
<th>Entrepreneur</th>
<th>Entrepreneur and Private Equity Firm</th>
<th>Private Equity Firm</th>
<th>Reports</th>
</tr>
</thead>
</table>
| Approaching the private equity firm/evaluating the business plan | • Appoint advisers  
• Prepare business plan  
• Contact private equity firms | | • Review business plan | |
| Initial enquires and negotiation   | • Provide additional information | • Meet to discuss business plan  
• Build relationships  
• Negotiate outline terms | • Conduct initial enquires  
• Value the business  
• Consider financing structure | |
| Due diligence                      | • Liaise with accountants / Liaise with other external consultants. | | • Initiate external due diligence | |
| Final negotiation and completion   | • Disclose all relevant business information  
• Negotiate final terms  
• Document constitution and voting rights | | • Draw up completion documentation | |
| Monitoring                         | • Provide periodic management accounts  
• Communicate regularly with investor/s | | • Seat on Board?  
• Monitor investment  
• Constructive input  
• Involvement in major decisions | |
| EXIT                               |                                           |                                           |                               |
An unquoted company’s P/E ratio will tend to be lower than a quoted company’s due to the following reasons.

- Its shares are less marketable and shares cannot be bought and sold at will.
- It often has a higher risk profile, as there may be less diversification of products and services and a narrower geographical spread.
- It generally has a shorter track record and a less experienced management team.
- The cost of making and monitoring a private equity investment is much higher.

The following are factors that may raise an unquoted company’s P/E ratio compared with a quoted company.

- Substantially higher than normal projected turnover and profits growth.
- Inclusion in a fashionable sector, or ownership of unique intellectual property rights (IPR).
- Competition among private equity firms.

Calculate a value for your company that will give the private equity firms their required rate of return over the period they anticipate being shareholders.

Private equity firms usually think in terms of a target overall return from their investments. Generally “return” refers to the annual internal rate of return (IRR), and is calculated over the life of the investment. The overall return takes into account capital redemptions, possible capital gains (through a total “exit” or sale of shares), and income through fees and dividends. The returns required will depend on the perceived risk of the investment – the higher the risk, the higher the return that will be sought – and it will vary considerably according to the sector and stage of the business. As a rough guide, the average return required will exceed 20% per annum.

The required IRR will depend on the following factors.

- The risk associated with the business proposal.
- The length of time the private equity firm’s money will be tied up in the investment.
- How easily the private equity firm expects to realise its investment – i.e. through a trade sale, public flotation, etc.
- How many other private equity firms are interested in the deal (i.e. the competition involved).

By way of illustration, assume an investor requires 30% IRR on an equity investment of £1,175,000.

<table>
<thead>
<tr>
<th>£1,175,000 becomes:</th>
<th>Year 1</th>
<th>plus 30%</th>
<th>1,527,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>At end of:</td>
<td>Year 2</td>
<td>plus 30%</td>
<td>1,985,750</td>
</tr>
<tr>
<td></td>
<td>Year 3</td>
<td>plus 30%</td>
<td>2,581,475</td>
</tr>
<tr>
<td></td>
<td>Year 4</td>
<td>plus 30%</td>
<td>3,355,918</td>
</tr>
<tr>
<td></td>
<td>Year 5</td>
<td>plus 30%</td>
<td>4,362,693</td>
</tr>
</tbody>
</table>

Therefore the investor needs to receive 3.7 times his money after 5 years to justify his investment risk, i.e. an IRR of 30% is equivalent to a multiple of 3.7 times the original investment.

Pre money and post money valuations

As the person seeking private equity finance you will be focused on the value of the company at the point in time that you are offering a stake in the company to the private equity firm in return for its investment in your company. This is the pre-money valuation, i.e. the value of the business or company before the particular finance raising round has been completed.

The post-money valuation is the value of the business after the finance raising round has been completed, i.e. after the private equity firm has made its investment. The private equity firm will be more focused on this than the pre-money valuation, as it is the post-money valuation that will be used as the benchmark for any subsequent rounds of financing or indeed for the eventual exit. To achieve the required return the private equity firm will be concerned at too high a post-money valuation.
As an example consider an entrepreneur who owns 100% of a company and is seeking an initial investment of £5 million from a venture capital firm. The venture capitalist reviews the proposition and offers to invest £5 million in return for a 40% stake in the entrepreneur’s company. Based on what the venture capitalist is prepared to invest in the company a 100% shareholding must be worth £12.5 million post investment. This is the post-money valuation.

The remaining 60% of the shares, held by the entrepreneur, are therefore worth £7.5 million. But before the investment by the venture capitalist the entrepreneur held 100% of the shares in the company. The venture capitalist has therefore valued the business before he makes his investment at £7.5 million. This is the pre-money valuation.

If the venture capitalist is concerned that the post-money valuation is too high, he will either put less money into the venture for the same equity stake or indeed increase his equity stake.

Other valuation methods
Private equity firms also use other ways of valuing businesses, such as those based on existing net assets or their realisable value.

Personal financial commitment
You and your team must have already invested, or be prepared to invest, some of your own capital in your company to demonstrate a personal financial commitment to the venture. After all, why should a private equity firm risk its money, and its investors’, if you are not prepared to risk your own! The proportion of money you and your team should invest depends on what is seen to be “material” to you, which is very subjective. This could mean re-mortgaging your house, for example, or foregoing the equivalent of one year’s salary.

Types of financing structure
If you use advisers experienced in the private equity field, they will help you to negotiate the terms of the equity deal. You must be prepared to give up a realistic portion of the equity in your business if you want to secure the financing. Whatever percentage of the shares you sell, the day-to-day operations will remain the responsibility of you and your management team. The level of a private equity firm’s involvement with your company depends on the general style of the firm and on what you have agreed with them.

There are various ways in which the deal can be financed and these are open to negotiation. The private equity firm will put forward a proposed structure for consideration by you and your advisers that will be tailored to meet the company's needs. The private equity firm may also offer to provide more finance than just pure equity capital, such as debt or mezzanine finance. In any case, should additional capital be required, with private equity on board other forms of finance are often easier to raise. The structure proposed may include a package of some or all of the following elements.

Classes of capital used by private equity firms
The main classes of share and loan capital used to finance UK limited liability companies are shown below.

Share capital
The structure of share capital that will be developed involves the establishment of certain rights. The private equity firm through these rights will try to balance the risks they are taking with the rewards they are seeking. They will also be aiming to put together a package that best suits your company for future growth. These structures require the assistance of an experienced qualified legal adviser.

Ordinary shares
These are equity shares that are entitled to all income and capital after the rights of all other classes of capital and creditors have been satisfied. Ordinary shares have votes. In a private equity deal these are the shares typically held by the management and family shareholders rather than the private equity firm.
Preferred ordinary shares
These may also be known as “A” ordinary shares, cumulative convertible participating preferred ordinary shares or cumulative preferred ordinary shares. These are equity shares with preferred rights. Typically they will rank ahead of the ordinary shares for both income and capital. Once the preferred ordinary share capital has been repaid and then the ordinary share capital has been repaid, the two classes would then rank pari passu in sharing any surplus capital. Their income rights may be defined; they may be entitled to a fixed dividend (a percentage linked to the subscription price, e.g. 8% fixed) and/or they may have a right to a defined share of the company’s profits – known as a participating dividend (e.g. 5% of profits before tax). Preferred ordinary shares have votes.

Preference shares
These are non-equity shares. They rank ahead of all classes of ordinary shares for both income and capital. Their income rights are defined and they are usually entitled to a fixed dividend (e.g. 10% fixed). The shares may be redeemable on fixed dates or they may be irredeemable. Sometimes they may be redeemable at a fixed premium (e.g. at 120% of cost). They may be convertible into a class of ordinary shares.

Loan capital
Loan capital ranks ahead of share capital for both income and capital. Loans typically are entitled to interest and are usually, though not necessarily, repayable. Loans may be secured on the company’s assets or may be unsecured. A secured loan will rank ahead of unsecured loans and certain other creditors of the company. A loan may be convertible into equity shares. Alternatively, it may have a warrant attached that gives the loan holder the option to subscribe for new equity shares on terms fixed in the warrant. They typically carry a higher rate of interest than bank term loans and rank behind the bank for payment of interest and repayment of capital.

Other forms of finance provided in addition to equity
Clearing banks – principally provide overdrafts and short to medium-term loans at fixed or, more usually, variable rates of interest.
Investment banks – organise the provision of medium to longer-term loans, usually for larger amounts than clearing banks. Later they can play an important role in the process of “going public” by advising on the terms and price of public issues and by arranging underwriting when necessary.
Finance houses – provide various forms of installment credit, ranging from hire purchase to leasing, often asset based and usually for a fixed term and at fixed interest rates.
Factoring companies – provide finance by buying trade debts at a discount, either on a recourse basis (you retain the credit risk on the debts) or on a non-recourse basis (the factoring company takes over the credit risk).
Government and European Commission sources – provide financial aid to UK companies, ranging from project grants (related to jobs created and safeguarded) to enterprise loans in selective areas – see above.
Mezzanine finance – loan finance that is halfway between equity and secured debt. These facilities require either a second charge on the company’s assets or are unsecured. Because the risk is consequently higher than senior debt, the interest charged by the mezzanine debt provider will be higher than that from the principal lenders and sometimes a modest equity “up-side” will be required through options or warrants. It is generally most appropriate for larger transactions.

Additional points to be considered
By discussing a mixture of the above forms of finance, a deal acceptable to both management and the private equity firm can usually be negotiated. Other negotiating points are often:

• Whether the private equity firm requires a seat on the company’s board of directors or wishes to appoint an independent director.
The investment process

• What happens if agreed targets are not met and payments are not made by your company?
• How many votes are to be ascribed to the private equity firm’s shares?
• The level of warranties and indemnities provided by the directors.
• Whether there is to be a one-off fee for completing the deal and how much this will be?
• Who will bear the costs of the external due diligence process?

Specific considerations relating to venture capital and management buyout deals

1. How a venture capitalist arrives at his required equity stake

In the case of a venture capital investment, in order to illustrate how a venture capitalist arrives at his required equity stake in a company, assume that we have an early-stage investment proposition that is looking for £10 million of investment and is projected to earn £20 million in year 5 which is the year the venture capitalist wishes to exit his investment. Similar quoted companies in the industry sector have average P/E ratios of 15. The venture capitalist discounts this by, say, 20% to allow for the fact that the company in which he proposes to invest is private and is a relatively early stage company and applies this discounted P/E to his investment’s earnings in year 5 to give a terminal value on exit of £240 million. The venture capitalist needs to discount this to the present day value based on his target IRR, using the formula:

\[
\text{Present value} = \frac{\text{Terminal value}}{(1 + \text{Target IRR})^n}
\]

where \(n\) is the number of years of the investment.

The venture capitalist sets the target IRR at 50%, commensurate with the risk of investing in this early-stage venture.

This therefore gives a present day, or discounted terminal value, of:

\[
\frac{240 \text{ million}}{(1 + 50\%)^5} = £31.6 \text{ million}
\]

The venture capitalist’s required stake in the venture is therefore his investment of £10 million divided by the present day value of £31.6 million, ie nearly a third of the equity (31.6%).

The deficiencies in using this method to arrive at the investor’s required equity stake are that the use of quoted company current P/E ratios may not reflect the state of the market at the time of the venture capitalist’s exit from the investment in a few year’s time and that the discount factor applied to the P/E ratio to reflect that the investee company is not quoted and different in other ways from the larger company are quite subjective. Of course the venture capitalist can play around with different discount factors and required IRRs to see how these affect the required equity stake.

2. Use of preference shares in structuring a venture capital deal

Venture capital finance is normally provided as a mixture of ordinary and preference shares with possibly debt hybrids and variations in classes of shares. How much of the venture capitalist’s equity is the form of ordinary shares or preference shares is open to negotiation.

Preference shares rank ahead of ordinary shares for both income and capital. The venture capitalist can attach various rights to the preference shares and these are discussed under the term sheet considerations below. These rights are not available to ordinary shareholders and can include, for example, rights with regard to liquidation preferences, or the right to receive cumulative or non-cumulative dividends or the right to convert their shares into ordinary shares, eg., in the event of an IPO, as well as anti-dilution provisions which protect the preferred shareholder from dilution resulting from a later issues of shares in connection with a subsequent financing round.

One of the most basic reasons for an investor wanting preference shares in the venture, rather than ordinary shares, is to protect his investment in the event of a liquidation or sale soon after investment. If he holds just ordinary shares along with the founder they will both receive any proceeds in proportion to their ordinary shareholdings, even though the venture capital investor is likely to have contributed substantially more to the venture, in terms of finance provided, than the founder. By holding preference shares the venture capital investor gets substantially more of his original investment back out in the event of a liquidation or a sale immediately post investment.
Whilst preference shares serve to protect the investor and can have various rights attached to them they do not themselves allow the investor to benefit from the growth and success of the investee company. There the preference shares usually have the ability to be converted into fully participating ordinary shares at any time at the option of the venture capital investors. As an exit opportunity approaches the venture capitalist will convert its preference shares into ordinary shares at the appropriate point when its holding is more valuable to the venture capitalist, in ordinary shares than in preference shares and participate in the exit opportunity.

Through this combination of ordinary shares and preference shares the venture capital investor can protect his downside exposure in the event of a liquidation whilst benefiting from the upside potential of the business. Also by having different classes of share, the venture capitalist does not have to wait for an exit to enjoy a return. Shares with preferred or participating rights may improve the overall rate of return to the investor by returning cash in the form of dividends rather earlier and at a greater rate than the ordinary shares are able to.

3. Management buyouts

In the case of a management buyout, whereby current operating management and investors acquire or purchase a significant shareholding in the company or subdivision they manage, the private equity firm often acts as overall sponsor, provides equity finance, leads negotiations with the sellers of the business or company, appraises the company’s ability to generate profits and cash, and introduces a syndicate of lenders to the deal such that the loans are tailored to the forecast cash generating capacity of the company being acquired. A key principle of management buyouts is the use of the target company’s assets, and especially its future cashflow, as the basis on which to fund the acquisition.

Value creation in a management buyout

The aim of the buyout is to rapidly increase the value of the company in order to maximise the returns of the shareholders. There are three main routes to creating value in a management buyout situation: earnings enhancement, financial engineering and multiple arbitrage.

1. Under the earnings enhancement approach the management team is able to grow profits by increasing revenues and/or cutting costs. This is particularly applicable in situations where the company being acquired has been poorly managed, where it is operating in a growth sector and the new management team’s skills can be used to enhance profitability by streamlining and improving operations and capitalising on growth opportunities. With even a relatively small annual increase in profits the value of the company will increase and, with increasing profitability, it is likely that the company will generate more cash, allowing more debt to be paid off than the debt that can be paid off under the financial engineering approach (see (2) below), or perhaps allowing a dividend to be paid to the equity holders.

2. The financial engineering approach to value creation simply uses the cash generating ability of the company to repay debt. This requires a tight focus on cash so that cash flow can cover the debt interest and principal repayments. Each debt repayment enhances equity value even if company itself does not grow in value through increasing its profits for example (although without projected profit growth a management team is unlikely to receive backing from a private equity firm). The financial engineering approach works well when there are low interest rates, the company is relatively stable and is not subject to significant competition.

3. There is also scope to add value through skills in buying and selling companies, i.e. by staging an effective sale process whereby the investor and management team can persuade a buyer that the company is worth a larger multiple of its annual earnings than it which it was acquired at the time of the buyout. Buying and selling at different profit multiples is the multiple arbitrage approach to value creation in buyouts. It is not usually assumed in forecast return models that a company will be sold at a higher profit multiple than that paid on acquisition but it is a reasonable assumption if you are buying in depressed markets and selling into more upbeat markets, having achieved operational and strategic improvements during the buyout period, and have the skills to better positioning the company for sale.

Management buyouts in the 1980s, especially in the USA, relied heavily on financial engineering and use of leverage. The sustained rise in the stock markets in the 1990s allowed for exits at high profit multiples. With the increase in acquisition prices for deals (as a multiple of profit) and difficulties
in repaying much higher levels of debt, financial engineering and multiple arbitrage have become less important. **Buyouts are now much more dependent on operational improvements and earnings enhancement to generate value.**

**Buyout structure**

The financial structure of a management buyout deal is carefully tailored to the cash and profit generating characteristics of the company that is the subject of the buyout.

A special purpose vehicle (Newco), which is a separate legal entity and usually a limited company with local or offshore incorporation, is created to make the acquisition of the target company (the company subject to the buyout). The equity capital is provided to Newco by the private equity firm and the management team. Bank (loan) finance is used to part fund the purchase of the target and to provide working capital. The security for the bank finance is the target’s fixed assets, operating assets, book debts plus usually a charge from Newco over the capital it will hold in the target. The funding is only committed once the acquisition actually takes place.

**Simple buyout structure**

<table>
<thead>
<tr>
<th>Vendors: loan notes</th>
<th>Banks: senior debt</th>
<th>Investors: shares/loan notes</th>
<th>Managers: shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>NEWCO</td>
<td></td>
<td></td>
<td>TARGET CO</td>
</tr>
</tbody>
</table>

The use of debt in the form of the bank loans helps maximise the equity returns, e.g. a debt/equity ratio of 80/20 can double the return on equity that would be achieved by a debt/equity ratio of 20/80. The debt element of the transaction has historically been between 70% and 95% of the total finance required.

**Debt finance in a management buyout transaction**

Banks can produce a blend of debt instruments, matched to their varying appetites for risk and demands for return and tailored to the forecast cash generating capacity of the target company. The range of debt products include senior debt, including revolving loans, term loans, capex term loans, second lien debt, mezzanine finance and high yield bonds, all of which rank behind the senior debt in terms of security and repayment in the event of a liquidation. There might also be the possibility of vendor financing from the seller of the company being acquired or an earn-out arrangement (deferred purchase consideration).

The return (usually in the form of interest) expected by the debt provider increases as the risk increases. Senior debt is secured on collateral, usually the assets of the target being acquired pledged as security for the loan. In the event that the borrower defaults on the terms of the loan, the assets may be sold, with the proceeds used to satisfy any remaining obligations. High-quality collateral reduces the risk to the lender and results in a lower rate of interest on the loan. In the event of bankruptcy, the senior debt provider is considered a secured creditor, which means the creditor receives proceeds from the sale of the collateral to satisfy the debt. Secured creditors, including the senior debt provider, must have their debts satisfied before any unsecured creditors receive any funds.

Other than straight cash, senior debt has the lowest risk financing, has the highest priority for interest and principal repayments and therefore requires less in terms of return (interest payments). Interest also increases proportionate to the term of the loan.
Senior debt A has the shortest maturity (e.g., repaid over 7 years). Senior debt B is repayable after all the A debt has been repaid, usually in two semi-annual instalments, followed by senior debt C which will have a maturity of, say, 9 years. B and C debt carry higher interest rates than A debt, as they have longer repayment terms.

A working capital facility is usually provided as part of the senior debt. It can be structured as a revolving credit facility or an overdraft. It will usually have a fixed term arrangement and provided there is no default on the part of the borrower, the lenders cannot withdraw the facility.

Second lien debt is also secured but ranks behind A, B, and C debt. It is usually repayable in a single repayment after 10 years and carries a higher interest rate than the A, B, and C debt.

Mezzanine debt is subordinated to senior debt, part of the interest is usually paid in cash and part rolled up into principal (known as a payment in kind or PIK). It often includes warrants or options to purchase equity shares in the borrower at a nominal price (equity kicker) which provides additional return to lender without a further fixed burden on borrower (but could have a higher interest rate in lieu of the equity kicker).

High yield debt is bonds or notes sold to investors through the publicly-traded debt markets. Interest is paid semi-annually at a fixed rate several basis rates above the rate for government bonds. The bonds or notes are repayable after 8 to 12 years. They are unsecured, ranking behind senior and mezzanine debt.

Institutional debt (or unsecured loan stock) is an integral part of the equity investment but in practice it is structured as debt rather than shares so that on exit (or liquidation) the bulk of the equity investor’s funds are repayable first before the management team receive any proceeds. If cash flows permit a running yield can be paid to the investor as interest payments on the debt without the need for retained profits needed to pay a dividend. Institutional debt is subordinated to all other debt, is unsecured and although it carries much higher risk than debt this is not reflected by higher interest rates. It looks like equity except to the management team (for whom it is effectively debt as it has to be repaid before management receive any share in the exit proceeds) and to the company’s unsecured creditors with whom it ranks equally.

The Offer Letter (Term Sheet)

Following the review and discussion of the business plan, initial investigation and enquiries, and negotiations on capital structure and other terms, and provided that the private equity firm is keen to do a deal with you, the private equity firm will send you an offer letter or term sheet. This sets out the general terms of the proposal, subject to the outcome of the formal due diligence process (see below)
and other enquiries and the conclusion of the negotiations. The term sheet, without being legally binding on either party, demonstrates the investor's commitment to management's business plan and shows that serious consideration is being given to making an investment. The term sheet represents the private equity firm's preferred terms and not necessarily and indeed, unlikely at this early stage in negotiations, your preferred terms.

The private equity firm may change the terms as the due diligence process and negotiations progress, for example adjustments to the overall valuation, refinement of ratchets etc.

The terms in the term sheet will be incorporated into the shareholders' agreement at the end of the negotiation process. It is better for the term sheet to be as detailed and unambiguous as possible so that there are no surprises when the eventual shareholders agreement has been drafted for you to sign.

You can obtain an example of an indicative term sheet from the BVCA. Whilst there are no standard term sheets you can expect that the term sheet will cover the following areas all of which are briefly described below:

- amount to be invested, instruments (eg. convertible preferred shares), valuation, capital structure;
- liquidation preferences, dividend rights, conversion rights, anti-dilution protection, redemption rights, lock-ups, pre-emption rights;
- board composition, consent rights, information rights;
- warranties, vesting, option pool, milestones;
- confidentiality, exclusivity, fees, conditions precedent.

Areas covered by term sheet

Amount to be invested and instruments
The term sheet will set out the amount that the private equity firm is to invest in the company, the format in which the investment is to be made, eg. convertible preference shares, and the number and price of the shares.

Valuation
The valuation (pre-money) should be firmly buttoned down in the term sheet. The pre-money valuation is the value of the business or company before the particular finance raising round has been completed.

Capital structure
The capital structure should be shown in the final term sheet both before and after the private equity firm's investment, on a fully diluted basis, including all share options.

Liquidation preferences
These are the right of the preference shareholder to receive before any other shareholders cash that is available in the event of the company being liquidated or indeed sold, as in a trade sale, or achieving an IPO. The private equity investor may express that he requires a multiple of his original investment in these situations.

Dividend rights
The right to receive dividends may be cumulative or non-cumulative. If cumulative the dividend due to the preference shareholder accrues even if the company does not have adequate distributable reserves to be able to pay a dividend when it is due. The accumulated dividends then become payable to the private equity firm in the event of a liquidation occurrence as above. Non-cumulative dividends are not accrued if the company does not have distributable reserves to pay them.

Conversion rights
Preference shareholders usually have the right to convert their shares into ordinary shares, for example in the event of an IPO. They will do this only if it is a ‘qualifying’ IPO where above a certain minimum
amount of capital is raised at above a minimum stock price. This protects preferred shareholders converting from preferred shares to ordinary shares in connection with an IPO that is too small or has no meaningful public market or liquidity for the shareholder.

**Anti-dilution provisions**
Anti-dilution provisions protect the preferred shareholder from dilution resulting from later issues of shares, in connection with a subsequent financing round, at a lower price than the private equity investor originally paid (known as a ‘down round’). Anti-dilution provisions in their most aggressive form are set up such that the lower share price of the later share issue is applied to the original, higher priced shares and the investor’s share holding adjusted as if he had invested at this lower price.

**Redemption rights**
Redemption rights require the founder or management team to buy back the private equity investor’s shares by a specific date. These rights are used if the business does not generate the growth required by the investor to give him his required capital gain. A multiple of what the private equity firm invested may be required to be paid back to the firm.

**Lock ups**
Lock-ups specify how soon after a flotation the management team and the private equity investor can sell their shares, which is important in making the shares attractive to public investors at the time of the IPO.

**Pre-emption rights**
Pre-emption rights apply when a company proposes to issue new shares and existing shareholders, such as the private equity investor, have the right to be offered a pro-rata part of the new shares before they are offered to a new shareholder in a way that does not dilute the original private equity shareholder. In relation to sales of existing shares, similar rights require a shareholder wishing to sell shares to offer them first to existing shareholders before being able to transfer them to outsiders.

**Board composition**
The private equity firm has the right to have a seat on the board of directors.

**Consent rights**
Consent rights give the private equity firm the right of veto over a whole range of areas even though the private equity firm may not have a majority of the shares with voting rights. Such areas could include the recruitment of new members of the management team, purchase of new equipment, corporate mergers and acquisitions, expansion overseas or into new markets, future finance raisings, issue of stock options, borrowing levels and the sale or flotation of the company. The private equity investor may set limits over which he wants the right of veto, for example new equipment purchases greater than £100,000 or borrowing limits greater than £250,000.

**Information rights**
Information rights will require the company to provide the private equity firm with copies of the monthly management accounts (including budget versus actual comparisons and explanation of variances), updated monthly cash flow forecasts, audited annual accounts, annual strategic plan and budget etc.

**Warranties**
The term sheet may require the management team to warrant certain information which the private equity firm is relying on in arriving at his investment decision. You will need to negotiate, with your lawyer involved, the nature, extent and limit of these warranties and what happens if they are breached in terms of indemnification (if the value of the company is reduced in the event of breach of warranty you may have to compensate the investor for the reduction in value) or contractual damages (if it can be argued that the shareholders have suffered no loss you might not have to pay the private equity firm in connection with the breach).
Vesting
The private equity firm may require the shareholder founders or management or other key employees to remain working with the company for a minimum term before they can realise the rights over all the options or all the shares ascribed to them. The shares are considered vested when an employee can leave his job, yet maintain ownership of the shares or exercise his options to obtain the shares with no consequences.

Options
The percentage of equity shares reserved for new options for existing and future employees should also be set out in the term sheet. This will affect the valuation of the company.

Milestones
Milestones are often used to set goals that the management team have to reach before additional tranches of capital are put into the company by the investor, or management salaries reviewed or share options granted.

Confidentiality
The term sheet will contain a clause on confidentiality, ie. that both the investor and the founder / management team will keep the fact that discussions are progressing between them confidential as well as agreeing not to divulge any information supplied.

Exclusivity
The private equity firm may want to include an exclusivity clause in the term sheet preventing you from talking with other private equity firms about investing in your proposition for a specified period of time, usually the period that the various due diligence exercises are carried out.

Fees
The term sheet will set out the basis on which the professional fees of the investor’s accountants, lawyers and other due diligence providers are to be paid. In addition, some private equity firms may charge a fee for doing the transaction (deal fee) and, post-investment, some private equity firms may charge the company for monitoring their own investment by taking a fee for the provision of non-executive directors appointed to the board.

Conditions precedent
Conditions precedent included in the term sheet include details on what has to happen between the term sheet being signed and the completion of the investment. This will include the satisfactory completion of the due diligence process and the completion of the various legal agreements, including the shareholders agreement and the warranties and indemnities documentation. Conditions precedent may also specify that you must do certain other things during this period, such as securing the contract with the major customer that you have informed the private equity firm is in process.

All of the above areas included in the term sheet are negotiable. The term sheet is only binding as regards exclusivity, confidentiality and fees. The term sheet will go on to form the basis of the final legally binding investment agreements (see below).

The due diligence process
To support an initial positive assessment of your business proposition, the private equity firm will want to assess the technical and financial feasibility in detail.

External consultants are often used to assess the commercial and market prospects and the technical feasibility of the proposition, unless the private equity firm has the appropriately qualified people in-house. References may also be taken up on the company (e.g. with suppliers, customers, and bankers) and on the individual members of the management team (e.g. previous employers). Advice may also be sought on the key commercial and structural risks facing the business in addition to assessments on the company’s technology base and intellectual property rights.
Chartered accountants are often called on to do much of the financial, and sometimes other, due diligence. This will include reporting on the financial projections and other financial aspects of the business plan. These reports often follow a detailed study, or a one or two day overview may be all that is required by the private equity firm. They will assess and review areas such as the following concerning the company and its management:

- Management information systems
- Forecasting techniques and accuracy of past forecasting
- Assumptions on which financial assumptions are based
- The latest available management accounts, including the company’s cash/debtor positions
- Bank facilities and leasing agreements
- Pensions funding
- Employee contracts.

These due diligence reviews aim to support or contradict the private equity firm’s own initial impressions of the business plan formed during the initial stage. If the private equity firm commissions external advisers, it usually means that they are seriously considering investing in your business. The due diligence process is used to sift out any skeletons or fundamental problems that may exist. Make the process easier (and therefore less costly) for you and the private equity firm by not keeping back any information of which you think they should be aware in arriving at a decision. In any event, you will have to warrant this in due course.

**Syndication**

When the amount of funding required is particularly large, or when the investment is considered to be relatively high risk, the private equity firm may consider syndicating the deal.

Syndication is where several private equity firms participate in the deal, each putting in part of the total equity package for proportionate amounts of equity, usually with one private equity firm acting as lead investor. Whilst syndication is of benefit to the private equity firm in limiting risk in the venture, it can also have advantages for the entrepreneur as syndication:

- Avoids any one investor having a major equity share and significant unilateral control over the business.
- Makes available the combined business experience of all the private equity partners to the benefit of the company.
- Permits a relatively greater amount of financing than with a single investor.
- Can offer more sources of additional future financing.

**And finally… Completion**

Once the due diligence is complete, the terms of the deal can be finally negotiated and, once agreed by all parties, the lawyers will draw up Heads of Agreement or Agreement in Principle and then the legally binding completion documents. Management should ensure that they both take legal advice and have a firm grasp themselves of all the legalities within the documents. The legal documentation is described in the next chapter.
**Additional private equity definitions**

**Burn rate**
The rate at which a company requires additional cash to keep going.

**Chinese walls**
Arrangements that prevent sensitive information being passed between different parts of the same organisation, to prevent a conflict of interest or breach of confidentiality.

**Dividend cover**
Calculated by dividing earnings after tax by the net dividend and expressed as a multiple. It shows how many times a company’s dividends are covered by post tax earnings.

**Earn-out**
Part of the price of a transaction, which is conditional on the performance of the company following the deal.

**Envy ratio**
The ratio between the effective price paid by management and that paid by the private equity firm for their equity stakes in the company. The higher the envy ratio the better the deal is for management. The ratio depends on how keen the private equity firm is to do the transaction, what competition they are facing and the general economic conditions at the time of doing the deal.

**Gearing, debt/equity ratio or leverage**
The total borrowings of a company expressed as a percentage of shareholders' funds.

**IPO**
Initial Public Offering, “flotation”, “float”, “going public”, “listing” are just some of the terms used when a company obtains a quotation on a stock market. Stock markets include the Official List of the London Stock Exchange, the Alternative Investment Market (AIM), NASDAQ (USA) and other overseas exchanges.

**Ratchets**
A structure whereby the eventual equity allocations between the groups of shareholders depend on either the future performance of the company or the rate of return achieved by the private equity firm. This allows management shareholders to increase their stake if the company performs particularly well.

**Yield**
Calculated by dividing the gross dividend by the share price and expressed as percentage. It shows the annual return on an investment from interest and dividends, excluding any capital gain element.
The role of professional advisers

The financial adviser, accountant and lawyer have important roles to play in the private equity process, both for the management team seeking finance and the private equity firm. It is often the case that the financial advisory role and the role of the accountant performing investigatory due diligence are performed by different teams within the same organisation. Your accountant may therefore be able to act as your financial adviser.

The financial adviser's role

The primary role of the financial adviser, for example in an MBO transaction, is to provide corporate finance advice to either the management team or the private equity firm sponsoring the transaction. Your financial adviser will provide you with impartial financial advice, independent of the private equity firm and its own advisers. The precise nature of the role varies from situation to situation but typically includes:

• Undertaking an initial appraisal of management's financing proposition.
• Advice on your business plan – critically reviewing and appraising your plan to ensure that it includes all the areas referred to in the business plan section of this Guide and that the business plan is framed and presented in accordance with the requirements of the private equity firms.
• Advice on valuation of the business and planning for the ultimate sale of the business and realisation of management and the private equity firm's investment.
• Undertaking financial modelling – carrying out sensitivity analysis on the financial projections to establish that the forecasts make accounting and commercial sense. Checking that they have been prepared in accordance with reasonable accounting policies and with due regard to publicly available information.
• Advice on the most appropriate capital structure to be used to fund your proposal.
• Making introductions to appropriate sources of private equity with investment criteria that match your business proposition and a business style that should be right for you. If your business is a highly attractive investment opportunity for private equity firms, this may include organising an “auction” or a “beauty parade” of private equity firms to compete for the right to finance your company. The financial adviser will need to ensure that the terms of the FSMA are properly complied with in providing this service.
• Making introductions to appropriate sources of debt and other finance to help to fund the proposal.
• Reviewing offers of finance – reviewing the terms of the deal offered by the private equity firms and other finance providers and assisting in negotiating the most advantageous terms from those on offer.
• Assisting in negotiating the terms of the deal with the private equity firms and banks and with the vendor.
• Project managing the transaction to minimise calls on management time and disruption to the business.
• Providing other advice, at a later stage if required, on the flotation of your shares on a stock exchange, or their sale to another organisation, or other such transactions.

The accountant's role

The primary role of the accountant acting on behalf of the private equity firm, in an MBO transaction for example, is to undertake investigatory due diligence. The precise scope of the accountant’s role varies from situation to situation but typically includes:

• Reporting formally on projections.
• Undertaking financial and commercial due diligence – often a prerequisite to private equity investment. The accountant will also be able to make informal judgmental opinions on aspects of the plan to the benefit of both management and the private equity firm.
• Undertaking pensions, IT or environmental investigatory work and due diligence.
• Providing audit, accounting and other advisory services.
• Planning your tax efficiently – help management obtain the maximum benefit from the tax system, whether the aim is for a public flotation or to remain independent, and to minimise tax liability on any ultimate sale of equity.
• Valuing your company’s shares – for tax planning and Inland Revenue negotiation.

Tax advice
The tax adviser will also help to ensure that, where possible:
• Tax relief is available for interest paid on personal borrowings to finance management’s equity investment.
• Potential gains on the sale of equity are taxed as a capital gain and not treated as earned income.
• Capital gains tax (CGT) is deferred on the sale of equity.
• Exposure to Inheritance Tax is minimised.
• Tax indemnities provided by the company directors and shareholders to the private equity firm are reviewed.
• Tax relief on professional costs in connection with an MBO, flotation or other exit is maximised.
• Share option plans are properly set up.
• Advantage is taken of appropriate plant and machinery, industrial buildings and research & development capital allowances.
• Corporate funding is structured to maximise tax relief.
• Tax due diligence procedures are properly carried out.

Your tax adviser can also explain the qualifying criteria under which personal investments can be made through the Enterprise Investment Scheme and in Venture Capital Trusts (both of which are described above).

If you require a chartered accountant or financial adviser with experience in the private equity field, see the “Associate Members – Professional Advisers” section within the BVCA’s Directory of members.

The lawyer’s role
Usually there are at least two sets of lawyers involved in the private equity process; one representing the management team and one representing the private equity firm. Other parties, such as bankers and other private equity firms, if acting as a syndicate, will each want their own lawyer involved.

The private equity firm’s lawyer
The lawyer is mainly concerned with ensuring that the private equity firm’s investment is adequately protected from a legal standpoint. The lawyer will draw up the various investment agreements, usually including the following:

- **Shareholders’ or subscription agreements**
  Documents detailing the terms of the investment, including any continuing obligations of management required by the private equity firm, the warranties and indemnities given by the existing shareholders, penalty clauses and the definition of shareholder rights.

- **Investors’ rights agreement**
  Specifies the rights of the private equity firm with regards to the investment.

- **Warranties and indemnities**
  Documents that confirm specific information provided by the directors and/or shareholders to the private equity firm. If this information turns out later to be inaccurate, the private equity firm can claim against the providers of the information for any resulting loss incurred. An indemnity is as a promise to indemnify, i.e. to reimburse the investors in respect of a designated type of liability if it arises.

- **Loan stock or debenture agreements**
  A statement of the terms under which these forms of finance are provided.
Service contracts
Documents that formalise the conditions of employment of key members of the management team.

Disclosure letter
Contains all the key information disclosed to the private equity firm on which the investment decision has been based. It is essential that the directors do not omit anything that could have an impact on that decision. The disclosure letter serves to limit the warranties and indemnities.

The management team’s lawyer
The management team’s lawyer will review the Offer Letter (the heads of agreement or Term Sheet) from the private equity firm and, together with your financial adviser, will help you to negotiate acceptable terms. The management team’s lawyer will also, in due course, negotiate the investment agreements with the private equity firm’s lawyer and produce the disclosure letter, as well as negotiating any loan documents with the banker’s lawyer.

In the case of a new company, your lawyer can incorporate the company and draw up the Memorandum and Articles of Association, which govern the constitution of the company, its permitted activities (which under the Companies Act 2006 can now be unrestricted unless the articles express otherwise) and the powers of its shareholders and directors. Under the CA 2006 when a new company is registered it must supply to Companies House a memorandum of association, but this is a simple form containing only the names and addresses of the subscribers and (in the case of a company limited by shares) the number of shares taken by each. The company must also have articles of association which can be based on the CA 2006 new Model Articles (one for private companies and one for public companies) although private equity investment articles will need to be fairly bespoke. Even in the case of an existing company, a new Memorandum may be required and new Articles almost certainly will be needed to document the dividend and other rights attaching to the company’s shares following the private equity investment.

If you need to find a lawyer experienced in these areas, refer to the “Associate Members – Professional Advisers” section of the BVCAs Directory.

Professional costs
In many cases, the costs of all the professional advisers will be borne by the company receiving the investment. The private equity firm will usually increase the funding provided to allow for these costs, so you and your team should not be “out of pocket” as a result, although you may be left with a slightly smaller equity stake. However, there are circumstances where this might not be possible, due to contravention of Company Law, or where it is agreed that each party bears its own costs.

Ensure that you agree the basis of costs before any work commences. In particular, ensure that you have firm agreement as to who is to bear the costs in the event of the negotiations being aborted. Usually in this case the private equity firm will bear the cost of work commissioned by them and you will pay the costs of your own professional advisers.

Professional costs incurred by the financial advisors, accountants and lawyers employed by the management team and the private equity firm, like any service, need to be carefully controlled. There is a range of costs that will depend on the complexity of the transaction, but will typically be around 5% of the money being raised.
Your relationship with your investor

Private equity for growth and success

Private equity investment has been demonstrated to contribute significantly to companies’ growth. Private equity backed companies outperform leading UK businesses.

The “2007 Economic Impact of Private Equity in the UK” shows that the vast majority of companies receiving private equity believe that without private equity they would not exist at all or would have developed less rapidly. Furthermore the report consistently demonstrates that private equity-backed companies increase their sales, exports, investments and people employed at a considerably higher rate that the national average.

While the growth and success of these companies owes much to private equity investment, enabling them to achieve their full potential, the non-financial input by the private equity firm is also a very important contributor. The private equity firm’s involvement generally does not end following the initial investment. Of the private equity backed companies analysed in this survey, annually over three-quarters say that their private equity firms make a major contribution other than the provision of money. Contributions cited by private equity-backed companies often include private equity firms being used to provide financial advice, guidance on strategic matters, for management recruitment purposes as well as with their contacts and market information.

Most private equity firms’ executives have a wide range of experience. Many have worked in industry and others have a financial background, but what is more important, all have the specialist experience of funding and assisting companies at a time of rapid development and growth. Levels of support vary, however, ranging from “hands-on” to “hands-off”.

Hands-on approach

• A “hands-on” or active approach aims to add value to your company. In addition to advising on strategy and development, including in such areas as entering new markets, overseas expansion, acquisitions and hiring new management, the private equity firm will have many useful business connections to share with you, possibly including introductions to potential customers, suppliers, headhunters, acquisition candidates and even to other private equity firms in connection with syndicating financing rounds.
• The private equity firm aims to be your business partner, someone you can approach for helpful ideas and discussion. The investor can act as a coach or mentor to you and your management team. Backing from a private equity firm can provide credibility and status in dealing with third parties. A hands-on investor is particularly suited to a company embarking on a period of rapid expansion. However, day-to-day operational control is rarely sought. In order to provide this support, some private equity firms will expect to participate through a seat on your board. The director may be an executive from the private equity firm or an external consultant and fees will need to be paid for the director’s services.
• The private equity firm will expect to:
  • Receive copies of your management accounts, promptly after each month end.
  • Receive copies of the minutes of the board of directors’ meetings.
  • Be consulted and involved in, and sometimes have the right to veto, any important decisions affecting the company’s business. This will include major capital purchases, changes in strategic direction, business acquisitions and disposals, appointment of directors and auditors, obtaining additional borrowings, etc.
Your relationship with your investor

**Hands-off approach**

Some investors will have a less active role in the business, a “hands-off” or passive approach, essentially leaving management to run the business without involvement from the private equity firm, until it is time to exit. They will still expect to receive regular financial information. If your company defaults on payments, does not meet agreed targets or runs into other types of difficulties, a typically hands-off investor is likely to become more closely involved with the management of the company to ensure its prospects are turned around.

**In reality**

Most private equity firms in reality tend to operate somewhere between these two extremes.

**Help to avoid the pitfalls**

One of the private equity firm’s positive contributions to your business might be to help you avoid receivership or liquidation. They can help you spot the danger signs of troubled times ahead and avoid business pitfalls.

**Examples of danger signs**

- Lack of response to changing environments
- Fixed price contracts
- Increasing level of fixed costs
- Cash flow problems
- Breaches in bank covenants
- Failing to meet capital interest or dividend payments
- Increasing overseas competition
- Over-trading
- Deteriorating credit control
- Uncontrolled capital expansion
- Inaccurate and/or untimely management information
- Autocratic management
- Financial impropriety
- Early success, but no staying power
- Over expansion and loss of control
- High turnover of key employees
- Extravagant executive lifestyle
- Dependence on too few customers/suppliers

**Tips for working with your private equity investor**

Here are some practical tips for a successful working relationship with your private equity investor:

- Work in a true partnership with your investor: share your issues and views as often as possible. Be completely transparent, disclose all news, including bad news! Don’t hide things from your investor. The private equity investor will find out anyway and he hates surprises!
- Listen carefully to the private equity firm’s advice and validate it; private equity and venture capital investors have typically seen many cases of developing and growth companies. They can help you in identifying issues ahead of time.
- Hire the right talent at the right time for your company together with your investor. Never compromise on the quality of management.
- Be open to advice from your investor to bringing in outside expertise where necessary.
- Have a clear plan about how to achieve sustainable earnings growth in the medium to longer term – don’t just focus on short-term targets.
- Demonstrate a strong focus on cash management to your investor and actively restrain cash spend.
- Prepare your exit strategy early in order to create maximum value for shareholders.
• Remember that once you have an external investor on board you have started the process of eventually selling your business, be it through a trade sale or flotation.
• Remember that the aim is to achieve maximum long-term value not only for the management team’s own reward (and the private equity firm’s) but with an ultimate purchaser in mind.

**Directors’ responsibilities**

As a company director you have onerous responsibilities to your shareholders and your creditors. Many of the duties and obligations of a director are mandated by the Companies Act 2006. Others are governed by the Insolvency Act 1986 (you should be particularly aware of the “wrongful trading” provisions contained therein) and the Company Directors’ Disqualification Act 1986. Under the wrongful trading provisions a director may, by court order, be made personally liable for a company’s debts if it is allowed to continue trading at a time when it was known, or should have been concluded, to be insolvent. Discuss any concerns with your private equity firm and other professional advisers before they become real problems and help to ensure success for you, your management team and your investors.

You should also have recourse to the Combined Code on Corporate Governance (2008) which is aimed at enhancing board effectiveness and improving investor confidence by raising standards of corporate governance. The code sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders. The Financial Reporting Council has recently undertaken a review of the Combined Code.

**Guidelines for success**

The following guidelines apply to most successful business situations:

• Stick to what you know – avoid industries in which you are not experienced.
• Encourage a common philosophy of shared business goals and quality standards so that you meet and even exceed the expectations of your customers. Communicate the objectives and results throughout your organisation.
• Avoid information overload – concentrate your management information systems on what is critical to success.
• Build your team – as your business grows, recognise the need to direct the company and to not be personally involved in each day-to-day decision, which should be delegated to senior managers.
• Cash flow – remember “cash is king”, take care to manage your cash resources with the utmost care.
• Anticipate problems – know what is going to be critical as your company moves through its various growth stages.
• Keep your investors, bankers and advisers informed – they are there to help and do not like surprises.
• Watch your costs – ensure that the market price of your products gives a profit contribution in excess of the costs you incur. This may sound facile, but it is amazing how often this is not assessed regularly, resulting in unexpected losses.
• Do not anticipate sales – the costs can grow by themselves, but the sales will not.
• Use the network – a well-developed set of business contacts is one of the keys to business success. These could include customers, suppliers, trade associations, Government agencies and professional advisers.
• Look for opportunities – the business plan is the agreed route forward for the business, but other opportunities will arise. Assess them, discuss them with your investors and pursue them if it makes sense for the business. Adapt your business plan as your company develops and new opportunities are considered.
Realising the investment

Many business owners and shareholder management teams are looking at some point to sell their investment or seek a stock market listing in order to realise a capital gain. Private equity firms usually also require an exit route in order to realise a return on their investments. The time frame from investment to exit can be as little as two years or as much as ten or more years. At the time of exit, the private equity firm may not sell all the shares it holds. In the case of a flotation, private equity firms are likely to continue to hold the newly quoted shares for a year or more.

The options

The five main exit options are listed below. If you are considering any of these, you will need the specialist advice of experienced professional advisers.

Trade sale
The sale of your company’s shares to another company, perhaps in the same industry sector.

Since the dotcom crash, the majority of venture capital exits have been achieved through trade sales. This can bring a higher valuation to the company being sold than a full stock market quotation, if the acquirer actually needs the company to supplement its own business area. But depending on the type of company seeking a listing on a stock exchange this may bring a higher valuation if it is creating a new industry.

Private equity firms tend to favour the trade sale exit route over an IPO because they can realise their investment in cash or cash and shares where the shares can be sold for cash. With an IPO the private equity firms may not be able to actually sell their shares for some time (the so-called “lock up” period). This also applies to the entrepreneur, founder or shareholder management team.

Repurchase
The repurchase of the private equity investors’ shares by the company and/or its management.

To repurchase shares you and your advisers will need to consult the Companies Act, which governs the conditions of this exit option. Advance clearance from the Inland Revenue and professional accounting and tax advice is essential before choosing this route.

Secondary Purchase
The purchase of the private equity investors’ or others’ shareholdings by another investment institution.

This type of exit may be most suitable for a company that is not yet willing or ready for flotation or trade sale, but whose private equity investors may need an exit.

Flotation
To obtain a quotation or IPO on a stock exchange, such as the Official List of the London Stock Exchange, AIM or NASDAQ (USA).

Going for an IPO or flotation has various attractions for the entrepreneur or shareholder management team, particularly when they are wanting to carry on with their involvement in the business, but there are also several disadvantages to be aware of. The various advantages and disadvantages of going public are summarised in the table below.
Also do not underestimate the amount of time that it takes to go through the flotation process. Whilst you are dealing with the investment bankers, the private equity firms, various sets of lawyers and accountants, endless prospectus drafting meetings, warranties and indemnities etc you also have to continue to run and grow your business. It is important not to take your eye off the ball during the arduous process. Expect to spend more of your time and that of your management team on the flotation than you did in raising private equity or venture capital. Following flotation you will also need to take the time to deal with investor relations including spending time with the press.

Involuntary exit
Where the company goes into receivership or liquidation.

### Going public
**Advantages**
- Realisation of some or all of the owner's capital.
- Finance available for expansion.
- Marketable shares available for acquisitions.
- Enhanced status and public awareness.
- Increased employee motivation via share incentive schemes.

**Disadvantages**
- Possible loss of control.
- Requirement to reveal all price sensitive information which may also be of interest to your competitors.
- Unwelcome bids.
- Continuing obligations – costs and management time incurred.
- Increased scrutiny from shareholders and media.
- Perceived emphasis on short-term profits and dividend performance.
- The cost.

### Valuing the investment on exit
For partial disposals and certain exits it is often necessary to arrive at a mutually acceptable valuation of the company. The “International Private Equity and Venture Capital Valuation Guidelines”, jointly prepared and endorsed by the BVCA and many other national private equity and venture capital associations, address the bases and methodologies to be used for valuing private equity and venture capital investments. These guidelines are aimed principally at private equity fund managers, to provide consistency and commonality of valuation standards amongst funds, largely for fund performance measurement purposes.
Before you do anything – read this!

Legal and regulatory issues you must comply with in raising finance

Raising finance is a complex legal and regulatory area and you should be aware of the need to take legal advice during the process. In particular, sending a business plan to, or discussing it with, potential investors, is a financial promotion and this may require you or other persons involved in the process to be authorised or regulated here in the UK. In some cases, if you are not authorised by the Financial Services Authority, you may be committing a criminal offence or agreements entered into may not be enforceable against the other parties. Whilst financial promotions sent by those seeking funds to private equity houses will, in most cases, be exempt from restrictions in the Financial Services and Markets Act 2000 (FSMA), we recommend that you seek professional/legal advice before communicating your plans to anyone.

The Financial Services and Markets Act (“FSMA”)

The FSMA provides that “a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity”. This does not apply if the person is an authorised person under the FSMA or the contents of the communication are approved by an authorised person. As you are likely to be raising finance to start-up or to expand your business it is unlikely that you will be authorised. The general prohibition is set out in section 21 of the FSMA, but the details of exemptions from this restriction are contained in the secondary legislation, mainly the FSMA 2000 (Financial Promotion) Order 2005 (Financial Promotion Order). There are over 65 exemptions in the Financial Promotion Order. You are recommended to take legal advice before applying any of these exemptions which need to be carefully considered in each case.

The Financial Promotion Order differentiates between real-time and non real-time communications. A real-time communication is one that is a communication made in the course of a personal visit, telephone conversation or other interactive dialogue. A non real-time communication is one that does not fall within the definition of a real-time communication and includes letters, emails and publications (including TV and teletext). The Financial Promotion Order also sets out indicators to look for when determining if a communication is a non real-time communication. The indicators include if the communication is directed to more than one recipient in identical terms or if the communication is made in a way that the recipient cannot or is not required to reply immediately or can refer to it at a later time.

The Financial Promotion Order also distinguishes between solicited and unsolicited real-time calls, solicited calls being ones which are initiated by the recipient or take place following an express request (which is more than mere acquiescence) from the recipient.

Some relevant exemptions to individuals or companies communicating business plans to potential investors include the following. There are various requirements and conditions that must be observed in taking advantage of these exemptions, all of which have not been included below, and you are recommended to take legal advice before applying any of these, or indeed the many other, exemptions.

Investment professionals

This exemption applies to financial promotions made only to recipients whom the person making the communication believes on reasonable grounds to be investment professionals. These are:

- Authorised persons
- Governments and local authorities
Before you do anything – read this!

- Exempt persons (where the financial promotion relates to a controlled activity which is a regulated activity for which a person is exempt).
- Persons whose ordinary business involves carrying on a controlled activity of the kind to which the financial promotion relates (i.e. private equity and venture capital firms, investment trust companies, large companies which have a corporate treasury function).

Also exempted are persons acting in their capacity as directors, officers or employees of such entities such as directors, officers or employees of authorised private equity and venture capital firms.

One-off communications

There are exemptions for one-off non real-time communications and solicited real-time communications which are made to (rather than directed at) recipients. To benefit from this exemption, the communication must be tailored and individual in nature and should not form part of an overall organized marketing campaign.

Certified high net worth individuals and self-certified sophisticated investors

Non-real time or solicited real time communications, relating only to investments in unlisted companies, are exempt if made to an individual who the communicator reasonably believes to be a certified high net worth individual or a self-certified sophisticated investor. The individual must have signed an appropriate statement within the period of 12 months prior to receiving the communication. High net worth individuals must have an annual income of not less than £100,000 or net assets to the value of not less than £250,000 (excluding primary residence, life assurance policies and pension). Self-certified sophisticated investors must be (1) a member of a network or syndicate of business angels and have been so for six months before the date of the statement, (2) he has made more than one investment in an unlisted company in the two years before the date of the statement, (3) he is working or has worked in the two years before the date of the statement in a professional capacity in the private equity sector or in the provision of finance for small and medium enterprises, or (4) he is currently or has been in the two years before the date of the statement, a director of a company with an annual turnover of at least £1 million, and (5) he accepts that he can lose his property and other assets from making investment decisions based on financial promotions.

Misleading statements

The FSMA generally prohibits the inclusion of misleading statements in documents that are designed to induce or persuade people to enter into investment agreements or to buy or sell shares in companies. This would therefore apply to your business plan. Any person who makes a statement, promise or forecast or dishonestly conceals any material facts, or who recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive, is guilty of an offence if he makes the statement, etc. for the purpose of inducing (or is reckless as to whether it will induce) another person to enter or offer to enter into an investment agreement. Sanctions for a contravention of these provisions includes imprisonment up to seven years or a fine or both.

It is therefore essential that, irrespective of whether or not any of the exemptions in relation to financial promotions apply, any statement, promise or forecast contained in any communication, document, including a business plan, private placement memorandum, information memorandum, etc., made available to potential investors is verified in order to ascertain whether by itself, or taken in the context in which it appears, it could possibly be misleading or false or deceptive. This verification could be carried out by an authorised person such as an investment bank, corporate finance boutique or authorised professional services firm. If however you are sending your plan to a UK private equity house which is itself authorised then you do not have to have this verification process undertaken. You should nevertheless ensure that the plan does not contain misleading statements.

In case of any doubt, if you are seeking equity or debt finance, other than ordinary banking facilities, you are recommended to obtain legal advice before making any communications (whether written or oral) with potential investors, including the circulation of your business plan.
Appendix – further information

Contact details

BVCA
1st Floor North, Brettenham House, Lancaster Place, London WC2E 7EN
Tel: +44 (0) 20-7420 1800
Fax: +44 (0) 20-7420 1801
Email: bvca@bvca.co.uk
Website: www.bvca.co.uk

The BVCA represents private equity and venture capital in the UK and is devoted to promoting the private equity industry and improving the performance and professional standards of member firms and the individuals within those firms. Its members include private equity firms, professional advisers, corporate financiers, mezzanine firms and other companies whose executives are experienced in the private equity field. The BVCA's primary objective is to increase awareness and general perception of private equity by:

- Providing information about members to those seeking private equity.
- Representing members’ views and interests in discussions with Government and other organisations.
- Providing a forum for the exchange of views among members.
- Acting as a source of education and training for employees of member companies.
- Developing and encouraging the highest standards of professional practice.
- Liaising with fund providers and political, regulatory and media contacts.
BVCA publications and research

Directory of Members
The Directory of Members lists private equity firms and their contact details, identifies their investment preferences (i.e. the minimum and maximum amounts, financing stage, industry sector and location). Also provides details of associate members including professional and other advisers, who are active in the private equity field. Published annually.

Report on Investment Activity
Analysis of private equity industry investment, by financing stage, industry sector, region and type of private equity company, with details on independent funds raised. Collated by PricewaterhouseCoopers. Published annually in May/June.

The Economic Impact of Private Equity in the UK
The major survey of private equity and venture backed companies analysing their growth and contribution to the national economy, measured in terms of job creation, sales revenues and exports against FTSE 100 and FTSE Mid-250 companies and national growth rates. Last published for 2007 in 2008.

Performance Measurement Survey
An annual report analysing the aggregate net returns to investors from independent private equity funds by year and type of fund. Produced by PricewaterhouseCoopers for the BVCA. Published annually in May/June.

A Guide to Investing in Europe
Produced jointly by the BVCA and Ashurst Morris Crisp, this publication assists private equity practitioners when investing in Europe. Topics covered include capital structure, board and employee matters as well as issues of common concern. Published in April 2002. Updated in June 2006.

Things I Wish I’d Known
Insights and inspiration from the journeys of 16 successful entrepreneurs. Published in October 2007.

A Guide to Term Sheets
This guide aims to provide those not familiar with the venture capital investment process with an outline of how investments can be structured, the terms and terminology used in a term sheet, and the broader investment process. Published in May 2004. Updated in October 2007.

For a complete list of BVCA publications and details on ordering, please visit the BVCA website www.bvca.co.uk.
Other useful contacts

British Bankers Association (BBA)
www.bba.org.uk

British Business Angels Association (BBAA)
www.bbba.org.uk

Business Link
www.businesslink.gov.uk

Capital for Enterprise Limited
www.capitalforenterprise.gov.uk

Department for Business, Innovation and Skills
www.bis.gov.uk
BVCA

Founded in 1983, the BVCA represents private equity and venture capital in the UK. We are devoted to promoting the private equity industry and improving the performance and professional standards of member firms and the individual within those firms.

This Guide to Private Equity was written for the BVCA by Keith Arundale, University Lecturer, Trainer and Independent Adviser: Private Equity & Venture Capital (www.keitharundale.com)

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