



Accountants &  
business advisers

# Raising private equity for growing businesses

A guide to attracting external investment





PKF is one of the UK's leading firms of accountants and business advisers and specialises in advising the management of developing private and public businesses. We pride ourselves on creating and sustaining supportive relationships in which objective and timely advice enables our clients to thrive and develop.

Our clients benefit from an integrated approach based on understanding the key issues facing small and medium-sized businesses. This enables us to meet their needs at each stage of development and allows them to focus on building the value of their businesses.

The principal services we provide include assurance and advisory; consultancy; corporate finance; corporate recovery and insolvency; forensic and taxation. We also offer financial services through our FSA authorised company, PKF Financial Planning Limited.

We have particular expertise in the following sectors:

- Charities
- Growing businesses
- Hotels
- Medical
- Professional partnerships
- Property & construction
- Public sector.

We have more than 1,500 partners and staff operating from offices around the country. Wherever you do business, we can offer you local expertise backed up by the resources of a national firm.

The UK firm is a member of PKF International, a network of independent firms of accountants and business advisers with 380 offices in over 115 countries.

These notes have been prepared as a general guide. They are not a substitute for professional advice. Neither PKF (UK) LLP nor its partners or employees accept any responsibility for loss or damage incurred as a result of acting or refraining from acting upon anything contained in or omitted from this guide.

PKF (UK) LLP is a limited liability partnership registered in England and Wales with registered number OC310487. A list of members is available at Farringdon Place, 20 Farringdon Road, London, EC1M 3AP, the registered office. PKF (UK) LLP is authorised and regulated by the Financial Services Authority for investment business and insurance mediation activities.

The PKF International Association is an association of legally independent firms.

PKF (UK) LLP operates a code of conduct to ensure that all types of data are managed in a way which complies with the Data Protection Act 1998. If you do not wish to be informed about the services we offer and forthcoming events, please contact your local office.



# Contents

---



<b>Introduction</b>		<b>3</b>
<b>Chapter 1</b>	<i>The five Ws of private equity – what, who, where, when and why?</i>	<b>5</b>
	<ul style="list-style-type: none"><li>– <i>What is private equity?</i></li><li>– <i>Who provides it?</i></li><li>– <i>Where do private equity firms source their funding?</i></li><li>– <i>When may SMEs need private equity?</i></li><li>– <i>Why private equity rather than loan finance?</i></li></ul>	
<b>Chapter 2</b>	<i>Attracting the right equity partner</i>	<b>11</b>
	<ul style="list-style-type: none"><li>– <i>What are private equity firms looking for from SMEs?</i></li><li>– <i>The private equity firm's dating checklist</i></li><li>– <i>How best to present your business to private equity firms</i></li><li>– <i>How to select the right private equity firm for your business</i></li><li>– <i>The role of professional advisers</i></li></ul>	
<b>Chapter 3</b>	<i>Doing the deal – the private equity investment process</i>	<b>19</b>
	<ul style="list-style-type: none"><li>– <i>The investment process – who does what when?</i></li><li>– <i>Agreeing the best funding structure</i></li></ul>	



- *Due diligence to completion*
- *Building a good relationship between the SME and your investor*

**Chapter 4**      *Management Buy-Outs – a quick overview*      27

- *What makes a successful MBO*
- *Achieving the right price*
- *Tax considerations*

**Chapter 5**      *Realising the investment – the exit options*      37

- *Trade sale*
- *Stock market flotation*
- *Secondary buy-out*

**Glossary**      41

**Useful links**      49





# Introduction

---



More than 1,600 UK businesses a year are now being financed by private equity firms<sup>1</sup> and the majority of them are medium-sized and fast growing. It is estimated that, in 2004, private equity backed companies generated sales of £187 billion, employed around 2.7 million people and, across all taxes, contributed around £23 billion to the UK Treasury.

The message is clear. The performance of these companies provides a significant boost to the economic performance of UK plc as a whole and improves our international competitiveness. Could private equity be the link between the following two facts?

1. *The UK private equity industry continues to be the largest and most developed in Europe, accounting for 47 per cent of total annual European private equity investment.*
2. *The UK economy has enjoyed more stable GDP growth than any other G7 country since 1997<sup>2</sup>.*

Either way, private equity funding is a catalyst for enabling well-managed, ambitious, growing businesses to reach the next level of growth and generate returns for investors and investees alike. Research from the British Venture Capital Association (BVCA) indicates that private equity backed companies achieve twice the annual growth rates of FTSE 100 companies.


The benefit to private equity backed companies is not just financial. More than three quarters of BVCA survey respondents<sup>3</sup> feel that their private equity funder has provided financial advice, guidance on strategic matters, market information and good contacts as well as funding.

1. A guide to private equity, BVCA

2. HM Treasury, August 2005

3. The economic impact of private equity in the UK 2004, BVCA





This booklet provides a guide for entrepreneurial businesses at various stages in your evolution where you need additional investment to help realise your vision for the business. It explains how the private equity process works, what the firms are looking for, and how you can both make your business attractive to prospective suitors and select the right one for you.

While the guide focuses on the two most popular reasons for needing private equity – expansion and management buy-outs – there is plenty of relevant advice for other stages of your evolutionary cycle.





# Chapter one

---



## *The five Ws of private equity*

### **What is private equity?**

Private equity is medium to long-term funding provided by individuals or firms to unquoted businesses with a high growth potential in return for an equity stake. As shareholders, the investors' returns are dependent on your performance and, as such, they take a much closer interest in how the business is managed than a provider of debt finance such as a bank.

The financing can be provided throughout the evolution of a business from start-up to exit, with different types of private equity investors specialising in different stages and industry sectors.


Confusingly, terms such as 'venture capital' are used differently in the UK, Europe and the USA. For example, 'venture capital' in the USA only refers to investment in the early stages while, in Europe, it is increasingly regarded as being synonymous with 'private equity' investment at every stage. In this guide, we use the term 'private equity' throughout to refer to all sources of private equity funding – whatever they may be.

### **Who provides it?**

There are three sources of private equity in the UK:

- *business angels*
- *private equity firms*
- *corporate venturers.*





Business angels are private individuals who typically invest small amounts directly in private companies in return for an equity stake. They tend to invest less than £100,000 at the seed, start-up or early stages of a company's evolution. This is the purest form of private equity available but also the most difficult to find as business angels tend to keep a low profile and drive a hard bargain on the terms of the deal.

At the other end of the scale are the corporate venturers. These are industrial or service companies likely to be in the same industry as you which either provide funding or a partnering arrangement.

The largest source of private equity is private equity firms that provide finance for every stage of a company's evolution. There are currently around 170 such firms in the UK – most of which claim to specialise in specific industry sectors or have a clear preference for a particular stage of investment such as start up, development or acquisition capital, or MBO funding.

### **Where do private equity firms source their funding?**

Private equity firms are in the same 'food chain' as companies looking for private equity, only higher up. The money that they lend to SMEs has to be borrowed and competed for from a range of external sources such as global institutions, pension funds, banks, governments, local authorities and insurance companies.

If, however, the private equity firm is a subsidiary of a bank or a parent company, at least part of the funding is likely to be obtained from the parent. These types of private equity firms are called 'captives' while those which raise their funds from external sources are called 'independents'.

In order to obtain their funding, private equity firms themselves have to convince institutional investors that they have a proven track record and can deliver a higher return on their investment in smaller high-growth companies than the institution could expect from other assets such as fixed interest or quoted equity investments or, indeed, from competing private equity firms. Funds raised from the institutions usually have a fixed life of ten years and private equity firms usually have more than one fund running at any one time.

Once a fund has been successfully raised, it can take two to three years to invest it wisely in a portfolio of investments with the potential to make significant gains. There is no fixed rule on the amount of the capital gain but you will often hear that investments need to make a 30 per cent internal rate of return (IRR) or achieve a cash return of three times the investment.



As it takes time – and an element of good fortune – to liquidate the portfolio towards the end of the life of the fund, it is not unreasonable to consider a typical investment period of three to six years for the growing SME.

### When may SMEs need private equity?

Private equity may be required at virtually any stage of the evolution of an SME. A glance through the BVCA Directory of members reveals that the most common stages are as follows:

Stages of investment	Type of investment
<p><b>Seed</b></p>	<p>Finance to enable the development of a business concept such as the production of a business plan, prototypes, market research etc.</p> <p>Only a few specialist private equity firms will consider seed investment as it is often not economically viable. Business angels or corporate venturers are more likely to be interested in seed financing.</p>
<p><b>Start-up</b></p>	<p>Finance to develop the company's products and services and fund the marketing. Private equity firms are more likely to be interested in high quality, multi-million pound start-ups than smaller ventures. Some also specialise in this stage of investment. Around 15 per cent of companies receiving private equity each year are start-ups<sup>4</sup>.</p>
<p><b>Other early stage</b></p>	<p>Finance for companies which have completed their product development but need additional funding to start production. This stage is increasingly popular among private equity firms and now accounts for around 20 per cent of all financing by BVCA members<sup>5</sup>.</p>

4. BVCA

5. BVCA



<b>Expansion</b>	This is often known as development or acquisition capital and is the most common stage for SMEs to receive private equity. It now accounts for around 50 per cent of all private equity financing <sup>6</sup> .
<b>Management buy-out (MBO)</b>	Funding to enable the existing management team to purchase a significant shareholding in the business that they manage. MBOs account for around 15 per cent of the number of financings undertaken by BVCA members but around 86 per cent of aggregate turnover.
<b>Management buy-in (MBI)</b>	Finance to enable an external manager or group of managers to buy into a company.
<b>Buy-in management buy-out (BIMBO)</b>	Finance to enable an internal management team to acquire the business they manage with the assistance of an incoming management team.
<b>Institutional buy-out (IBO)</b>	This is the purchase of a company by a private equity firm after which the new management team will be given or acquire a shareholding in the business.
<b>Secondary purchase</b>	This is when a private equity firm purchases shares in a company from another private equity firm or from another shareholder.
<b>Refinancing bank debt</b>	This is finance provided to reduce a company's level of gearing.
<b>Replacement capital</b>	This is finance provided to facilitate a partial realisation by the current shareholders but with no change to the management team.



6. BVCA

## Why private equity rather than loan finance?

Although entrepreneurs have persuaded wealthy individuals to invest in their businesses for centuries, this more informal way of financing a business only turned into a recognised industry in the late 1970s and early 1980s. One of the best known and largest private equity firms is 3i, the name given to the merger of the Finance Corporation Industry (FCI) and the Industrial and Commercial Finance Corporation (ICFC) in 1983. Around 170 private equity firms invested over £5.3 billion in 1,301 companies in 2004<sup>7</sup>.

Although private equity firms take a certain amount of risk in investing in growing businesses, the industry goes from strength to strength in line with the performance of privately backed companies – over three quarters of whom cite the relevance of the non-monetary contribution of their backers in their success.

The main difference between private equity and loan finance is that a loan is usually secured on either business assets or on the personal assets of the directors. If the business defaults on its repayments, the lender can put the company into administration and, in extreme cases, even bankrupt you if you have given personal guarantees. This type of secured debt is known as ‘senior debt’ because it takes precedence for repayment over unsecured creditors. In return for this security, senior debt is a relatively inexpensive form of finance.

Private equity ranks behind the senior lender in the security food chain. As long as there is significant senior debt outstanding, the backing firm is, in reality, unsecured and as vulnerable to the risk of failure as the other shareholders. As an equity business partner, the private equity firm both gains from success and loses from failure. As a result of this exposure to risk, private equity is considerably more expensive than senior debt.

The table on the following page comparing private equity to senior debt is taken from the BVCA publication ‘A Guide to Private Equity’.

7. BVCA.



<b>Private equity</b>	<b>Senior debt</b>
Medium to long-term	Short to long-term
Commitment until exit	Not likely to be committed if safety of loan is at risk. Overdrafts payable on demand and loan facilities payable on demand if covenants are not met
Provides a solid, flexible capital base to meet future growth and development plans	Useful source of finance if the debt to equity ratio is conservatively balanced and the business has good cash flow
Good for cash flow as the capital repayment, dividend and interest costs are tailored to the company's needs and affordability	Requires regular good cash flow to service interest and capital repayments
The returns to the private equity investor depend on the business's growth and success. The more successful, the better the return	Dependent on the business continuing to service its interest costs and maintaining the value of the assets on which the debt is secured
If the business fails, private equity investors will not have any preferential treatment and may lose their investment	If the business fails, the lender generally has first call on the company's assets
If the business runs into difficulties, the private equity firm will work hard to ensure that the company is turned around	If the business appears likely to fail, the lender could put your business into administration in order to safeguard its loan. It could also make you personally bankrupt
A business partner, sharing in the risks and rewards and offering practical advice and expertise to assist your business success	Available assistance varies considerably





# Chapter two

---



## *Attracting the right equity partner*

There are many similarities between finding the right equity partner and finding the right life partner. Each party has a view about what they want from the relationship and a list of criteria that the partner must fulfil in order to attract them.

The analogy is even more relevant for ‘lonely hearts’ who may not even know where to start looking for the right partner and need the services of a dating agency to facilitate an introduction with suitable candidates.

In this chapter, we outline how potential partners and their professional advisers can work together to create the perfect match.

### **What are private equity firms looking for from SMEs?**

In simple terms, private equity firms are looking to invest in businesses with strong growth prospects that are managed by experienced, skilled, ambitious people driven by the need to succeed.

These businesses typically have business plans that show evidence of a strong market demand for their product or service, a competitive edge for their product or service, a defensible market position, a strong management team with complementary skills, a vision for the future and a clear and credible strategy for achieving it.

As most private equity firms have their own investment preferences, your business must also fit their requirements for the size and stage of investment, industry sector and geographical region.




If a private equity firm can tick these boxes, the next priority will be to establish whether your business is capable of delivering the level of capital gains required to satisfy the objectives of the fund and its stakeholders. If the private equity firm is going to invest £10 million, it will be looking for a typical target return of three times the investment – £30 million. It goes without saying that the higher the risks associated with the investment, the higher the target return needs to be.

### The private equity firm’s dating checklist

Before you start to look for funding from a private equity firm, make sure that your business has the right prerequisites to attract one. Can you answer ‘yes’ to the questions below?

	Yes	No
1. Does your business have high growth prospects and the potential for sustained growth?		
2. Are you and your team hungry for growth?		
3. Have you got a product or service with a competitive edge and unique selling proposition (USP) in the marketplace?		
4. Do you understand the marketplace, industry sector and likely trends that you face over the next few years?		
5. Can you provide sufficient detail to substantiate your revenue projections for the period of the investment?		
6. Have your management team got the right industry sector experience and complementary areas of expertise (e.g. leadership, marketing, finance)?		
7. Is your management team fully committed to the business – both financially and intellectually?		
8. Have you got a clear, measurable strategy to achieve your business objectives?		
9. Is there a credible route towards the realisation of the investment? Will the business be ready for a sale or exit within the typical three to seven year timescale of a private equity firm?		
10. Are you willing to relinquish some control to an external party?		





If so, then it is time to start marketing your business proposal in order to attract the right suitors.

### **How best to present your business to private equity firms**

There are many good sources of guidance on how to write an effective business plan and this booklet does not aim to replicate their advice. We simply want to focus on the areas of the business plan that private equity firms will be most interested in and provide some basic guidelines for attracting external investment.

## ***Tips for attracting an investor with your business plan***

- 1. Write the business plan yourself – private equity firms want to find out what you and your management team are planning to do with your business – not how well a professional writer can gloss up the proposition.*
- 2. Aim for a high standard that is supported by robust financial models and evidence of real market knowledge and understanding.*
- 3. Make it readable by writing it in plain English without jargon or fluff.*
- 4. Make it long enough to be convincing but short enough to hold the reader's interest. The actual length will depend on the size and complexity of your business and how much funding you are seeking but, if in doubt, err on the side of brevity. If the plan is of interest, the private equity firms will ask for additional information.*
- 5. Make it look professional – lay it out well with a logical structure and good use of graphs and charts to illustrate financial information.*
- 6. Take care over spelling, grammar and punctuation as mistakes will create a disproportionately bad impression.*



The contents should include the following sections:

- **Executive summary** – a crisp and punchy summary of the key information and selling points which balances a persuasive argument with solid supporting facts. Write this last.
- **The product or service** – explanation of what you are offering and why it is different, better, cheaper, faster etc.
- **Market analysis** – size, growth rates, competitors, number of potential customers, market share that you are aiming for.
- **Marketing plan** – strategy and tactics for how you are going to achieve your market share including price, place (or distribution channels) and promotion.
- **The management team** – this is one of the most important sections as private equity firms are supporting people whom they must be able to trust and rely on to realise their investment. Include relevant biographies of skills and track records.
- **The business operation** – explain how you make or source the products or deliver the service. Provide full details of your plant, equipment and premises.
- **Financial projections** – include a balance sheet, income statement and cash-flow projections for a three to five year period. Be realistic about both future sales and costs and show the impact on profit and cash flow of both best and worst-case scenarios. Avoid being over-optimistic and demonstrate that you have thought through potential challenges and difficulties.
- **Amount of finance required** – explain how much is required and what other sources can be used (e.g. government grants, funds from directors, friends and associates, bank lending or overdraft facility) to supplement private equity.
- **The risks** – be realistic. No business proposition is risk-free and any bad news will eventually be uncovered. Address the potential risks head on and detail your credible response
- **The likely exit options** – e.g. trade sale, flotation – to show how a return can be made.





## How to select the right private equity firm for your business

A private equity firm cannot be selected by opening up the directory of members of the BVCA or the EVCA and sticking in a pin. You should only be targeting a small handful of private equity firms that match your particular circumstances. No two firms have exactly the same preferences and the only thing that they all have in common is a desire to make money.

As already outlined, the key criteria are as follows:

- *The stage of your development for which you require private equity – e.g. seed, start-up, expansion, MBO etc*
- *The industry sector in which you operate*
- *The amount of money that you require*
- *Your geographical location.*

A good starting point for your initial search is the BVCA Directory which lists its private equity firm members together with professional advisers and other providers of finance.

However, as with life, there is no substitute for personal recommendation of a particular firm from people who have worked with them and who will have an insight into whether you would be right for each other.

### The role of professional advisers

A multitude of professionals are involved during the course of a transaction, with each party appointing their own team to assist. The key players and their roles are summarised below.

#### 1. The role of the financial adviser

The role of the corporate finance or financial adviser will obviously vary according to the purpose for which you require the funding. As the 'lead' adviser, he or she will manage the whole funding process for you from beginning to end.



The financial adviser's services will typically include the following:

- *Detailed scrutiny and critical appraisal of the business plan to ensure that it includes all the information that a private equity firm may be looking for plus any additional input required*
- *Advice on the valuation of the business*
- *Assistance with modelling the financial projections*
- *Undertaking sensitivity analyses of the financial projections to ensure that they are realistic and robust*
- *Advice on the most appropriate capital structure to use to fund your proposal e.g. senior debt, private equity fund, management contributions etc. Your adviser will also have specialist funding models to demonstrate the impact of various funding structures on your business*
- *Matchmaking to find the best partner for you. If you represent a very attractive catch for private equity firms, a financial adviser may organise a 'beauty parade' for you so that you can put your suitors through their paces*
- *Tax planning advice*
- *Reviewing the deals offered by the private equity firms and negotiating terms for you*
- *Introducing you to other sources of finance to help fund the proposal – these may include senior bank debt, mezzanine finance, working capital and asset-based finance*
- *Review of the legal documentation*
- *Project managing the transaction so that you can continue to focus on running your business.*





## 2. The role of the Reporting Accountant

The Reporting Accountant is jointly appointed by the private equity investor and, if applicable, the bank or other funders. His or her role is to undertake a detailed investigation into the financial affairs of the company – financial due diligence.

The scope of work will ultimately depend on the complexity of the business but will typically include a detailed review of:

- *The last three years' profit and loss account, balance sheet and cashflow with reference to audited accounts*
- *The internal controls, business processes and management information systems*
- *The three year financial forecasts as presented in the business plan*
- *The tax history including PAYE, NIC, VAT, stamp duty and corporate tax compliance*
- *Pension plans and insurance policies.*

## 3. Commercial due diligence

Either separately or as part of the scope of financial due diligence, the funders will appoint professionals to undertake a detailed review of the business's products, customers, markets and competitors to try to validate the key assumptions that you have made about revenue growth in your business plan. This process may well include references from key suppliers and customers.

## 4. The role of the lawyer

Each party in the transaction will have their own lawyer. Your lawyer's main role will be to prepare and structure the various legal agreements that will govern the terms and relationship between the different parties. He or she will work closely with your financial adviser to:

- *Co-ordinate the preparation of legal due diligence 'bundles' in response to questionnaires issued by your funders*



- *Negotiate the investment agreements and loan documents prepared by your funders' respective lawyers. These will include a shareholders' agreement between you and the private equity firm and bank loan documentation*
- *Draw up any Memorandum and Articles of Association that will be required*
- *Prepare a range of other documents such as directors' service contracts, share option schemes etc.*

### **Who pays?**

As the company receiving the investment, the bad news is that you have to bear the costs for all the professional advisers. The private equity firm may increase the funding to allow for these costs but there is no such thing as a free lunch and, although this means that you will not be out of pocket, you may be left with a smaller shareholding as a result.

Try to agree the basis of these costs before the clock starts running for the professional advisers so that there are no nasty surprises when the deal is done.



# Chapter three



## *Doing the deal – the private equity investment process*

The private equity investment process from start to finish can take up to a year in extremely complex situations but transactions are usually completed within three to six months. As with most complex transactions, the timing depends on the quality and availability of the information provided to the private equity firm and the efficiency and competence of the professional advisers working with you to facilitate the deal.

### **The investment process – who does what and when**

<b>What/who</b>	<b>You</b>	<b>Your professional advisers</b>	<b>You and private equity firm</b>	<b>Private equity firm</b>
Appoint advisers	√			
Prepare business plan	√	√		
Review and appraise business plan		√		
Value the business	√	√		
Contact private equity firms	√	√		
Consider financing structure		√		



What/who	You	Your professional advisers	You and private equity firm	Private equity firm
Introductions to possible funders	√	√	√	
Conduct initial enquiries				√
Provide additional information	√	√		
Meet to discuss business plan	√	√	√	
Start to build relationship			√	
Review financial offers of private equity firms		√		
Negotiate outline terms		√		
Selected preferred funders	√	√		
Due diligence – liaise with accountants and other external consultants		√	√	
Disclose all relevant business information	√			
Negotiate final terms		√	√	
Draw up completion documents		√		√
Completion		√	√	

### Agreeing the best funding structure

Once your business plan has been finalised, your adviser will consider the various funding structures available to you, highlighting the key attributes of each possible source of funding together with the risk factors.

The feasibility of various funding scenarios will be considered until a preferred structure is determined. This will then form the basis of the initial approach to funders.

The difference sources of finance are summarised as follows.





## Debt finance

The first step when putting together a financing structure is to evaluate the level of debt that the business can support. It is usual for 'senior debt' to be the source of at least half of the total funding required. The proportion will depend on the strength of your forecasted cash flow, the level and quality of physical asset security available, and the ability of the business to satisfy the performance covenants imposed by the bank.

Most debt will have to be repaid within a specified period which is usually between five and seven years.

In any debt package, the key features to consider are the interest rate, the repayment or amortisation terms, the security required and the financial covenants.

## Equity finance

Equity funding will typically be provided from two or three sources depending on the nature of the transaction – the institutions, management (in the case of an MBO or MBI) and, sometimes, the existing shareholders or a vendor. The institutions will invest using a number of instruments – the main ones of which are preferred ordinary shares and 'quasi equity' in the form of loan stock.

The structure of the share capital proposed by the private equity firm will aim to balance the risks it is taking with the rewards they are seeking. The bulk of the institutional equity will be in redeemable non-equity preference shares or loan stock to enable its investment to rank ahead of the ordinary shares in terms of redemption, dividends and shareholders' rights. The institutional preferred equity is therefore a powerful instrument that strengthens the position of the institution within the business.

Ordinary shares are typically the shares held by the management and family shareholders rather than the private equity firm.

Preferred ordinary shares may also be known as 'A' ordinary shares and are simply equity shares with preferred rights.

Loan capital ranks ahead of share capital for both income and capital. Loans will be secured on the company's assets and trade but will rank behind any senior lender.





The key features for you to look out for in any offer of equity finance will include:

- *The overall structure of the deal and the relative split of ordinary shares, loan stock and other instruments*
- *The existing shareholders' retained equity share and any further funding that the private equity firm may require you to provide. In the case of an MBO, it is the management equity stake and personal cash investment required that need to be carefully considered*
- *Whether any equity stake is dependent upon a specific level of performance such as a ratchet being achieved by the business (do note that, while there are many good commercial reasons why an equity ratchet may be considered, they do require very careful structuring to avoid some nasty tax implications)*
- *Non-financial terms such as any constraints over the operation of the business*
- *The dividend and interest structure.*

### **Mezzanine finance**


This type of finance is most commonly required for larger deals or MBOs. It fills the gap between the secured debt that your business can support, the acceptable equity investment, and the total funding required. It ranks in terms of risk, return and security between senior debt and share capital.

As mezzanine debt ranks below senior or bank debt in priority of repayment, the interest charged will be higher than that from the senior lender. The overall return required is usually between 15 and 20 per cent which is roughly half way between the standard expectations of the senior debt and institutional equity providers. This return can be achieved through either an expensive interest rate, a premium on redemption, and/or a small equity stake (sometimes referred to as a kicker).

### **Vendor finance**

This is also only relevant to MBOs and is increasingly becoming an element in the funding proposal, as vendors seek to retain a share in the equity value of the business that they





have built up. Vendor finance can also be used to bridge any price gap between vendors and buyers. It can take the form of deferred loans from the vendor or shares subscribed by them. The vendor may also take shares in the new entity alongside the new management.

Armed with your preferred structure, along with detailed models highlighting this structure incorporated into your business plan, your adviser will approach a number of finance providers to try to secure initial interest. Presentations and meetings will follow, after which indicative offers of finance should be expected.

In determining which providers to work with, the various competing offers will be analysed, modelled and evaluated to see which best meets the objectives of the management or existing shareholders. A series of negotiations and further meetings will follow, during which offers may be fine-tuned, until a decision needs to be made.

Once a deal has been agreed, you will receive a formal offer letter from each party providing finance. This will set out the general terms and conditions of the proposal, subject to the outcome of the due diligence.


### **Due diligence to completion**

Due diligence is the name given to the detailed investigation undertaken by relevant professionals such as accountants and lawyers into the technical and financial feasibility of the proposed deal. It comprises financial, legal and commercial investigations and has a twofold purpose.

Firstly, particularly with regards to legal due diligence, it provides a substantial amount of detailed information on the business (remember that, at this stage, your backers have only received basic information largely contained in the business plan). Secondly, it provides independent assessment and (hopefully) validation of your financial projections. It will identify any existing or potential problems that could prevent your company from achieving its performance targets and failing to deliver the expected return on investment for the finance providers.

The good news about due diligence is that it means that the private equity firm is serious about investing in your business. The best approach that you can take is to co-operate fully and willingly with their investigations.





Once the due diligence has been completed to the satisfaction of all parties, the terms of the deal can be finalised.

### **Legal documentation**

In parallel with the due diligence process, the legal documents will be drafted. These will include shareholder or subscription agreements (including warranties and indemnities), loan stock and bank loan documentation (including security documents), new or amended Memorandum and Articles of Association, and director service contracts. Where there is a sale (or purchase) event, a share purchase agreement will also be required.

Do ensure that you fully understand these documents and are clear about all the conditions. Do not sign anything that you either do not fully understand or are not comfortable with. Your financial and legal advisers will spend considerable time with you on these documents.

### **Financial assistance**

Financial assistance occurs when a company's shares are being acquired and that company provides assistance to the purchaser. It is a hugely complex area of company law. Where there is financial assistance, the directors of the company are required to make statutory declarations regarding the solvency of the company over the 12 months following the giving of the financial assistance. The company's auditors will also be required to report.


### **Building a good relationship with your investor**

Your relationship with your investor will not end as soon as the ink is dry on the completion documents. Part of the 'courting' process on your part will be to establish what other contribution or support your private equity partner can make to the development of your business.

This could include financial advice, marketing knowledge, access to their business network, strategic guidance, and assistance with recruiting new members of the management team from their source of contacts.

The level of support and guidance given will vary and will be somewhere along the spectrum that is 'hands-on' at one end and 'hands-off' at the other. Invariably, your investor will appoint a Chairman to the Board of Directors to act as his eyes and ears. It is the chairman who, over time, will build the closest relationship with you. Your private equity firm will also take a further seat on the Board. This will usually be one of the team who executed the investment.





The choice of chairman is a key decision. A well-connected, experienced chairman will prove to be value for money over time.

### **A hands-on approach**

This type of investor is particularly useful to companies entering uncharted waters such as a period of rapid expansion or diversification into either a new product or market. You may have a young management team who would particularly benefit from the experience and track record of your investor. Thus the relationship with the private equity firm will be more akin to an alliance or partnership than that of a provider of finance.

### **A hands-off approach**

At the other end of the spectrum, investors may adopt a passive or hands-off approach that lets you get on with running your business without any involvement until it is time to realise their investment.

You will, of course, have to provide regular financial information and ensure that you meet your performance targets but, providing that you meet these requirements, you will be left to get on with it.

However, the reality is that your relationship with your investor will fall somewhere between these two approaches, depending on your circumstances at any particular time. They may involve themselves more if you find yourself entering a sticky patch, and then withdraw when everything is running smoothly again.

You will probably find that the relationship settles down after the initial honeymoon period into one of mutual convenience based on good communication and an understanding of each other's needs.







# Chapter four

---



## *Management buy-outs – a quick overview*

One of the most common uses of private equity is to fund a management buy-out. This is a transaction whereby the management of a business acquires a significant stake in that business by the combination of personal investment and funding from a private equity firm in conjunction with bank finance.

The MBO market in the UK is mature and well-established and was valued at £20 billion in 2004<sup>8</sup>, the second highest value ever recorded and the second consecutive annual rise in the value of completed transactions. MBOs are an increasingly popular solution for vendors and investors alike, as a well-planned and executed MBO can offer a win-win situation for all parties.

The management team gains an opportunity to take the business in the direction that they want and to participate financially in the capital gain when the business is eventually sold. The private equity firm benefits from an annual revenue stream and a capital gain on exit. As MBOs tend to be well-established businesses with proven management teams and steady revenue streams, the risk for the private equity firm is also considerably less than for an investment in a start-up or early stage of development – although the sums invested tend to be larger. Last but not least, a MBO has many advantages for the vendor, such as speed, flexibility and deliverability, as the existing management team already knows the business.

8. Centre for management buy-out research (CMBOR)



Events that most typically present an opportunity for an MBO include:

- **Retirement** – where there is no obvious successor within a family company at the time when the owner-manager is contemplating retirement
- **Shareholder disputes** – in privately owned companies with a number of shareholders at different stages of their work and life cycle, an MBO can be a useful means of buying out shareholders who no longer share the corporate vision or who want to sell their shares
- **The disposal of non-core activities** – where a company wishes to dispose of certain trading activities which no longer contribute to the main business
- **Receiverships** – there is a tendency for the management team to attempt an MBO to preserve their jobs but this should never be the driver behind such a decision. Unless the new team is confident that it can resolve the underlying reasons for the business failure, it may be simply throwing good money after bad.

In spite of its increasing popularity as a vehicle for realising financial gain, not every business can meet the necessary criteria to achieve a successful MBO.

### What makes a successful MBO

There are five principal elements to achieving a successful MBO that satisfies the objectives of all parties:

- A strong management team with the necessary skills
- A commercially viable business
- A willing vendor
- A realistic exit plan
- And, buying the business at a sensible price!





## **A strong management team**

This is the most important factor of all. Just as 'location, location, location' is the key consideration for property, so 'management, management, management' is the mantra for private equity firms.

While leadership is always important, an external investor will also need convincing that the management team has the right balance of skills and experience to develop the business and achieve its performance and growth targets. There also needs to be clear evidence that every member of the management team is fully committed to the deal and to working towards a common goal for the future of the business. Any waverers or weak links in the management team need to be dealt with as early as possible in the process.

The team will include the following:

- *A chief executive or managing director with the right experience, leadership and management skills to drive the business forward*
- *A finance director who understands both the business and the marketplace and can maintain rigorous financial controls and a management reporting regime*
- *A sales director who understands the marketplace and the competition, and who can deliver profitable sales through effective marketing and selling of the products or services*
- *An operations director who understands the processes, technologies and costs associated with delivering the product or service, and who is continually seeking improvement to achieve a competitive edge.*

## **A commercially viable business**

A proven track record of solid achievement is a base line for attracting financial backing. Your business must be capable of operating as a commercially viable entity that has:

- *an established market position and a solid, defensible market share*
- *good growth prospects*
- *regular and reliable income and cash flows*



- *a balanced customer base without over-dependence on one customer*
- *good profitability*
- *robust financial systems and controls*
- *a proven track record.*

### **A willing vendor**

Although this is obvious, both the owner and the management team should still take the time to think through the implications of the MBO route so that they fully understand the advantages.

The main advantages of an MBO include:

- **Speed** – *if all parties co-operate, the due diligence can be quickly achieved and a realistic and fair deal agreed. This will reduce the time spent by management and advisers alike, which will allow the operation of the business to continue more smoothly and may reduce the overall costs of the transaction*
- **Continuity** – *if you have spent several years building up your business, you will have considerable emotional attachment to it and will want to leave it to a team that you have recruited and developed, rather than for it to pass into the hands of a competitor through a trade sale*
- **Flexibility** – *there are many ways to structure the finance for a buy-out and it is possible – though not necessarily desirable – for the vendor to continue to have a stake in the new venture. This flexibility can rarely be matched by trade buyers*
- **Deliverability** – *the existing management team will put forward a realistic offer that is founded on a detailed knowledge of the business. The offer is likely to be more credible than an offer from a third party without inside knowledge*
- **Confidentiality** – *will prevent the release of 'sensitive' information to competitors who may also be potential trade buyers.*





### A realistic exit plan

The structure of most MBOs depends on the ultimate sale of the business and the capital gain to be achieved. Most private equity firms will have formulated an exit strategy before backing a buy-out and it is clearly an advantage if the management team's exit plan matches that of their investors.

While it is difficult to be specific about the timing and nature of an exit, serious consideration needs to be given to who could be a potential buyer when the time comes.

### Achieving the right price

The total finance for an MBO has to cover the purchase price, the transaction costs, any funding required for capital expenditure or working capital, and the costs of existing loans to be refinanced.

The most important element is, of course, the purchase price, so it is vital that a sensible valuation of the business is achieved in the early stages of the deal. The consequences of paying too much for the business will be harsh for both the managers and the private equity firm, as the higher the 'entry' cost, the higher the 'exit' price needs to be to generate target returns. Your investor will, therefore, require a greater proportion of the equity in return.

Valuing the business is not an exact science and there is always an element of judgement involved in arriving at a bid price. In broad terms, the value of the enterprise is the sum of the value of the equity plus the value of the debt. Therefore, the value of the equity is the value of the enterprise minus the value of the debt.

So how is the value of the enterprise calculated? The three main methods used are earnings based valuations, net asset valuations and discounted cash flow techniques.

**Earnings based valuations** are the most commonly used measures and express value in terms of a multiple of profits. It is quite usual for private company valuations to be based on multiples of EBIT or EBITDA (earnings before interest and tax, or earnings before interest, tax, depreciation and amortisation) which may be considered to approximate to annual cashflow.



The multiple is a broad measure of the quality and size of the earnings and will reflect a number of factors including sector risk, market share, better than average sector growth, skilled people, good operational systems and an earnings spread. The broader the range of strengths within the business, the higher the multiple is likely to be.

The example below shows the importance of the EBIT and underlying business strength in determining both the original MBO price and the exit price. It also illustrates the three key components that drive a capital gain: strong profit growth, de-gearing from cash flow generated and multiple arbitrage (although this latter component is largely driven by the vagaries of the wider capital markets and therefore cannot be assumed to occur in every deal).


	At MBO	EXIT 1 after four years	EXIT 2 after four years	EXIT 3 after four years (underperformance)
<b>EBIT</b>	£3.57m	£6m	£6m	£3m
<b>Multiple</b>	7	7	9	6
<b>Enterprise value</b>	£25m	£42m	£54m	£18m
<b>Senior debt</b>	£12m	£4m	£4m	£6m
<b>Mezzanine debt</b>	£5m	£5m	£5m	£5m
<b>VC loan stock</b>	£7m	£7m	£7m	£7m
<b>Equity</b>	£1m	£26m	£38m	£nil
<b>Capital gain</b>		£25m	£37m	£nil

**Exit 1:** Business performs in line with business plan, profits are successfully grown, senior debt substantially paid down.

**Exit 2:** As for Exit 1 except buoyant capital markets lead to an improvement in sector multiples.

**Exit 3:** The business underachieves against plan and falls behind with senior debt repayments. Multiple reflects poor track record.





**Net asset valuation** is based on the value of the assets less any liabilities on the balance sheet. However, this simple method overlooks the fact that the valuations on the balance sheet may be different from the market value and may also not provide any indication of the cash-generating ability of the business. There also may be a discrepancy if an FRS 12 evaluation of the liability of a long property lease has not been accounted for, but this is not ordinarily relevant except for certain specialist asset-based businesses such as property, investment trusts etc.

The third method of **discounted cash flows** (DCF) is based on the principle that the value of any asset is the present value of the future cash flows it will generate. DCF will use the cash flow projections of the business and the cost of capital raised to finance the deal to value the business.

The right price will be arrived at through a combination of knowledge and understanding about the business and its marketplace, confidence levels in the management team, and a view about future prospects. There will always be a level of risk that cannot be predicted – just think of the impact on the airline, tourism, travel and retail sectors caused by unforeseen events such as 9/11, SARs, and the 7/7 London bombings.


Once the price has been agreed, the different options for structuring the funding will be put together by the financial advisers (see Chapter 3). Their challenge will be to put together an integrated package of funding which enables the purchase price and the resulting costs of the deal to be paid, as well as providing a sustainable source of working capital for the business to operate.

## Tax considerations

### Management

It is likely that the management team taking part in any buy-out will be financing the purchase with personal borrowing. It is possible for the individuals concerned to claim tax relief for interest paid on such borrowing, provided the loan is used to buy shares in a company that is, at the time of purchase, “close”. However, there are strict conditions for the company to qualify as “close”. These conditions can be breached if an outside investor (such as a venture capital company) takes a significant stake in the company. It is, therefore, important to complete the transaction in the correct order so that tax relief is obtained.





In recent years, the Government focused its attention on tax avoidance involving the issue of shares to employees. For example, the employment-related securities legislation taxes employees who receive shares at a discount from their market value. Care must be taken with any arrangements that involve shares issued to the management team to ensure that they do not breach anti-avoidance legislation and that all notification requirements are met.

There can be substantial advantages to investors if the company meets the qualifying criteria to fall within the Enterprise Incentive Scheme (EIS). Investors may be able to defer a capital gains tax liability on the disposal of other assets (gains are deferred until the new shares are disposed of). Investors can also qualify for 20 per cent income tax relief on an investment of up to £200,000 in EIS shares but only if the individual investor is not taking a major stake in the new business or was previously involved in running it. Therefore, although EIS status can be helpful in raising capital, it may not be of significant direct benefit to those in the management team.

For inheritance tax purposes, shares in a close company will normally qualify for business property relief of up to 100 per cent (depending on the assets of the company) after the two year qualifying period. However, it is important to ensure that there is no arrangement that would oblige the executor of a deceased member of the original management team to sell the shares to the other members of the team. Under such circumstances, the relief would be lost.


Members of the MBO team may also wish to repay or reduce their personal borrowings at the earliest practical date. It is often tax-efficient for shareholders to extract cash from the business by way of dividend rather than salary or bonus payments but, if there are venture capital investors, this may not be possible. It is sensible to prepare for such needs during the MBO planning process so that all members of the team have realistic expectations.

### **New company**

The costs of an MBO to the new company formed to acquire the existing business can be significant, and it may not be possible for it to obtain immediate tax relief if the profits of the new company are low. This may cause cash flow difficulties for the new company, so it is important that funding for such costs is put in place at an early stage.

Trading losses that a company incurs can usually be offset against profits it generates in subsequent years. However, there are very strict rules on tax losses that are incurred before a change in ownership of a company being offset against profits arising after the change.





Therefore, if a company that has tax losses carried forward is the subject of an MBO, the purchasers will wish to ensure that under the new ownership structure it will be able to claim the losses or, if not, adjust the purchase price accordingly.

### **The vendor**

A sale of the company will be a capital gains tax disposal for the vendor. The amount of the vendor's liability will depend on what taper relief is available (and this will depend on a number of factors – see Chapter Five). The vendor may accept some of the acquiring company's paper (shares or loan stock) so that the capital gain can be rolled into the new shares or deferred on acquiring certain types of loan stock.

Such arrangements reduce the cash needed to acquire the business but the vendor will want to tie in the key management team afterwards to ensure that the forecast results are achieved. This is particularly the case where agreement cannot be reached on an appropriate price based on forecast earnings. However, the vendor will wish to ensure that the tax position on the earn-outs (which could be taxed as part of the capital gain on disposal of shares or as employment income, depending on the terms) is the most tax-efficient in the circumstances. This is an area fraught with uncertainty and there can often be prolonged negotiations on the precise terms of the deal.







# Chapter five

---



## *Realising the investment – the exit options*

Although the exit may seem far in the distance when you do the deal with your private equity firm, the reality is that everything en route to the exit is simply a means to that end – the point at which the investment is turned into a capital gain. Sooner or later, your investor will want an exit, be it after three years or seven.

The three main exit options are:

- *Trade sale*
- *Flotation*
- *Secondary buy-out.*

Although an important driver of exit timing is the investors' need to realise their investment fund and pay returns to their shareholders, the exit is equally likely to be driven by the general condition of the capital markets, the state of the economy in general, and the strength or weakness of merger and acquisitions activity.

The UK buy-out market is currently very buoyant, with the record number of 317 exits in 2004, a sharp rise in both trade sales and IPO exits, and a record level of secondary buy-outs<sup>9</sup> which contributed £7.1bn to the total exit value of £20.4bn.

9. Centre for management buy-out research (CMBOR)



## Trade sale

This is the sale of your company's shares to another company – probably a competitor in your own industry. The majority of exits are realised through a trade sale that provides a complete exit for the private equity firm.

Where the buyer can achieve significant cost savings from synergies, the trade sale should deliver the highest value for the shareholders.

## Tax considerations for a trade sale

A potential buyer may want to buy the company by acquiring the shares, or may simply want to buy the trade and assets of the company. As a general rule, it is often more tax-efficient to sell the shares rather than the assets of the company.


## Taper relief

It is widely known that, as of April 2002, qualifying business assets owned for two years or more can qualify for business asset taper relief. This reduces the taxable capital gain by up to 75 per cent to give an effective tax rate on gains of 10 per cent for individuals paying tax at 40 per cent. Unfortunately, the qualifying conditions are not so widely known and the significance of having acquired the asset prior to April 2000 is rarely appreciated. Many business owners simply assume that the relief will be available and fail to take the appropriate action to preserve entitlement.

Though this is a complex area, the most common problem is simply that shares in a company do not qualify for the relief because the company itself does not qualify as 'trading'. To assess whether or not a company is trading for this purpose, HM Revenue & Customs (HMRC) will seek to establish if its non-trading activities are substantial by applying a 20 per cent test to:

- *the non-trading income generated*
- *company assets (including surplus cash) used in a non-trading activity*
- *the proportion of total expenses that relate to non-trading activity*
- *management time spent on non-trading activity.*





The 20 per cent test is only a guide but it is vital that company owners regularly check that the 20 per cent limits will not be breached in any ten year period of ownership before realising their investment. If they are, the amount of taper relief on sale could be reduced and the tax liability increased.

### **Assets sale**

Any sales of assets by a company could lead to double taxation: corporation tax on the gains in the company and income tax to be paid on any cash you extract. A more tax-efficient way to extract funds may be through the payment of pension contributions if this fits in with your plans for the future.

In addition, balancing charges or allowances will affect the taxable profits of the business, where assets on which capital allowances have been claimed are sold, or where trading ceases. Depending on the asset values, these can add to the profits of the last trading period.

That said, selling the business piecemeal does allow the owners to retain certain items – for example, patents, intellectual property or business premises, even though the trade has been sold. This means you can retain ongoing income.

### **Stock market flotation**


Flotation on a public market such as AIM, OFEX, NASDAQ or the Official List is an option, although the larger markets are only a suitable exit for quality businesses valued in excess of £100 million.

Even so, it may be necessary for all investors to maintain a significant stake at the point of flotation, which means that a flotation is initially only a partial exit, with further tranches of value realised over time (and at the mercy of the markets). For more information, please consult PKF's flotation guide, *Going Public*.

### **Flotation and tax**

For the owners of shares in the company, the main capital gains tax considerations of a flotation are effectively the same as a share sale. Retaining shares in the new company will effectively defer the liability. However, if gains were 'held-over' by you on acquisition of the original shares, e.g. where the shares qualified under the Enterprise Investment Scheme, these gains will crystallise on flotation (unless the new company also qualifies under the scheme).





Owners who intend to retain shares in the listed company will continue to qualify for business property relief from inheritance tax, provided the company is floated on AIM. However, if the company opts for a full listing on the London Stock Exchange (the Official List), it is highly likely that this relief would not be available on the owner's death.

### **Secondary buy-out**

Since their appearance in 2002, secondary buy-outs have become a major feature of the market, with many of the largest exits now taking this route.

This is where a new team of younger managers raise more institutional funding to acquire the business from the existing team or, indeed, where one private equity investor sells to another, thereby realising his investment.

### **Tax considerations for a secondary buy-out**

The tax relief for sales of substantial shareholdings by companies has increased the 'second-hand' market for venture capital companies and many now sell on their investments after the initial growth/investment period. This increased flexibility, at no tax cost to the corporate investor, may put management teams under pressure from investors.

Where a secondary buy-out is engineered by a new management team, the tax issues for both sides are the same as outlined in Chapter Four.





# Glossary

---



Here is a glossary of some terms used in this booklet.

## **AIM**

The Alternative Investment Market is less rigorous and expensive than the Official List and can provide an exit for the original backers of a business.

## **Angel**

A successful entrepreneur who can provide money and experience to a management team starting up a new venture.

## **Beauty parade**

An accepted way of selecting financial and professional service providers which involves drawing up a short list of candidates and inviting them to pitch for your business.

## **BIMBO**

Buy-in management buy-out – a combination of management buy-out and buy-in where the team buying the business includes both existing management and new managers.

## **Burn rate**

The rate at which a company uses up its cash. By dividing what you have left by this you can calculate how long you can stay operational.

## **Chinese walls**

Arrangements put in place to prevent sensitive information being communicated between different parts of the same organisation to avoid conflict of interest or breach of confidentiality.



## **Completion**

The moment when legal documents are signed and funds are advanced by investors.

## **Debenture**

A legal document which formalises the lender's charge over the assets of the company.

## **Debt**

This may include bank loans, overdrafts and lease financing, and may be long or short term, secured or unsecured. The lender receives interest at an agreed rate and, in the event that this is not paid, may be entitled to take control of and sell certain assets owned by the company. A lender does not generally have a share in the ownership of the business.

## **Development (or growth) capital**

This is long-term equity capital raised to allow an already established company to grow without relying wholly on bank debt.

## **Dividend cover**

This is the multiple that is calculated by dividing the earnings after tax by the net dividend. It shows how many times a company's dividends are covered by post-tax earnings.

## **Due diligence**

This is the detailed analysis and appraisal that takes place before the transaction is completed. The aim is to ensure that there is nothing that contradicts the financier's understanding of the current state and potential of the business. The individual elements of due diligence may include commercial due diligence (markets, product and customers), a market report (marketing study), an accountants' report (trading record, net asset and taxation position) and legal due diligence (implications of litigation, title to assets and intellectual property issues).

## **Earn out**

The part of the price of the transaction that will be paid out to individual directors/shareholders if the company reaches its performance targets following the deal.

## **EBIT**

Earnings before interest and tax.



## **EBITDA**

Earnings before interest, tax, depreciation and amortisation. EBITDA is measure of cash flow. By excluding interest, taxes, depreciation and amortisation, the amount of money a company is bringing in can be clearly seen.

## **Equity**

Equity is the term used to describe shares in a business conveying ownership of that business. The shareholders may be entitled to dividends. If a business fails, the shareholders will only receive a distribution on winding up after the lenders and creditors have been paid. An equity investment, therefore, has a higher risk attached to it than that facing a bank lender and thus the return that the shareholders demand on their money is typically higher. The most common source of equity finance for buy-outs is the venture capital market.

## **Exit (Realisation)**

The point at which the institutional investors realise their investment. Private equity firms may, depending on the business and their own situation, look to achieve an exit in anything from a few months to 10 years. Exits generally occur via trade sales, secondary management buy-outs and flotation on the stock market, or by write-off if the investment ends in receivership.

## **Gearing or debt/equity ratio or leverage**

The ratio of debt to equity capital or the total borrowings of a company expressed as a percentage of shareholders' funds. The lower the gearing, the less the risk.

## **Goodwill**

The difference between the price which is paid for a business and the value of its assets. It includes the business's reputation and contacts.

## **IBO**

An institutional buy-out. This is when a private equity firm acquires a business directly from the vendor and installs its own management team. Often the target's management will take a small stake.

## **IPO**

An initial public offering is when shares in a company are placed on a stock exchange for the first time. If a company has a listing on another market or in another country, then the listing is not an IPO, merely a secondary or additional listing.



## **IRR**

The Internal Rate of Return is the average annual compound rate of return received by an investor over the life of their investment. This is a key indicator used by institutions in appraising their investments.

## **Joint venture**

Two or more companies that form a new venture.

## **LBO**

Leveraged buy-out is an American term that describes the takeover of a company by investors who use the company's own assets as collateral to raise the money which finances the bid. Normally, the loans are then repaid either from the company's cash flow or by selling some of its assets.

## **LBU**

Leveraged build up is when a venture capital firm builds up the company it owns by acquiring smaller companies to amalgamate into the larger firm, thus increasing the total value of its investments through synergies between the acquired companies.

## **LIBOR**

The London Interbank Offered Rate is the most common reference point used by banks for quoting their rate (e.g. 2 per cent over LIBOR)

## **LMBO**

A large management buy-out.


## **Loan note**

A loan note is a form of vendor finance or deferred payment in which the purchaser acts as a borrower, agreeing to make payments to the holder of the transferable loan note at a specified future date.

## **MBI**

A management buy-in is when the company is sold to a new team of managers who take a majority stake. This often happens with family firms which have no-one to pass the company





on to. The old owners sometimes retain a small stake. The management team often includes a venture capital firm. However, if the venture capital firm takes a majority stake, then the deal is classed as an IBO, rather than an MBI.

### **MBO**

A management buy-out is the purchase of a business by its management, usually in co-operation with outside financiers. Buy-outs vary in size, scope and complexity but the key feature is that the managers acquire an equity interest in their business for a relatively modest personal investment. The existing owners sell most or usually all of their investment to the managers and their co-investors. If the outside financier (e.g. private equity firm) takes a majority stake, then the deal is not an MBO but rather an IBO.

### **Merger**

True mergers are actually quite rare. Many acquisitions are described as mergers but, in a true merger, there is a one-for-one share swap for shares in the new company. If the swap is not on equal terms, then this is an acquisition.

### **Mezzanine finance**

This is often used to bridge the gap between the secured debt that a business can support, the available equity and the purchase price. Because it normally ranks behind senior debt in priority of repayment, unsecured mezzanine debt commands a significantly higher rate of return than senior debt and often carries warrants (options to buy ordinary shares) to subscribe for ordinary shares. It ranks behind more formal borrowing contracts and is thus referred to as 'subordinated' or 'intermediate debt'.

### **Net asset value**

This is the value of the company based on the valuation of the assets less any liabilities that it has in its balance sheet.

### **Newco**

A new company formed to effect the buy-out by acquiring the operating subsidiaries.



### Ordinary shares

Ordinary shareholders carry full rights to participate in the business through voting in general meetings. They are entitled to payment of a dividend out of profits and ultimately repayment of capital in the event of liquidation, but only after other claims have been met. As owners of the company, the ordinary shareholders bear the greatest risk but also enjoy the fruits of corporate success in the form of higher dividends and/or capital gains.

### PBIT

Profit before interest and tax.

### P/E ratio

The Price Earnings ratio is one of the most commonly used measures of value in financial circles. It expresses the value in terms of a multiple of profits. For any company quoted on the Stock Exchange, this figure can be easily calculated and is published daily in the Financial Times.

### Preference shares

These are part of the capital of a company that fall between debt and equity. They usually carry no voting rights and have preferential rights over ordinary shareholders regarding dividends and ultimate repayment of capital in the event of liquidation.

### Private equity

Private equity is an increasingly widely used term in Europe and is generally interchangeable with venture capital, but some commentators use it to refer only to the management buy-out and buy-in investment sector.

### Public buy-in

Individual or group of individuals purchasing a majority stake in a publicly quoted company.

### Public to private buy-out

This involves the management of a private equity provider making an offer for the shares of a publicly quoted company, then taking the company private.





### **Ratchet**

A mechanism whereby the management's equity stake may be increased (or decreased) on the occurrence of various future events, typically when the institutional investor's returns exceed a particular target rate.

### **Reverse takeover**

When a small company takes over a larger one or when the company being taken over is likely to have the major interest in the new combined business.

### **Secondary buy-out**

This is when a new management team together with a private equity funder acquire the business to enable the existing private equity supplier to exit from its investment.

### **Second-round financing**

Most companies need more than the initial injection of capital, whether to enable them to expand into new markets, develop more production capacity, or to overcome temporary problems. There can be several rounds of financing.

### **Senior debt**

Debt provided by a bank, usually secured and ranking ahead of other loans and borrowings in the event of a winding up.

### **Shares**

Certificates or book entries representing ownership in a business.

### **Start-up capital**

Capital used to establish a company from scratch or within the first few months of its existence. It is high-risk but can yield huge potential returns for the very successful.

### **Subordinated loan**

Loans which rank after other debt. These loans will normally be repayable after other debt has been serviced and are thus more risky from the lender's point of view. Mezzanine finance is an example of a subordinated loan.



### **Syndicated investment**

Where an investment is too large, complex or risky, the lead investor may seek other financiers to share the investment. This process is known as syndication.

### **Trade sale**

A common method of exit is a sale to a trade buyer. This can either allow management to withdraw from the business, or it can open up the prospect of working in a larger enterprise.

### **VCTs**

Venture capital trusts are specialist investment trusts which offer tax advantages to investors willing to provide money for investment in unquoted companies.

### **Vendor finance**

Can either be in the form of deferred loans from, or shares subscribed by, the vendor. The vendor may well take shares alongside the management in the new entity. This category of finance is generally used where the vendor's expectation of the value of the business is higher than that of management and the institutions backing them.

### **Venture capital**

Equity finance in an unquoted, and usually quite young, company to enable it to start-up, expand or restructure its operations entirely. It is initially cheaper than bank finance because the payment of dividends can be deferred. It also provides a strategic partner but it does involve handing over some control, a share of earnings and decisions over future sales.

### **Warranties and indemnities**

Legal confirmation given by the seller, regarding matters such as tax or contingent liabilities, to assure the buyer that any undisclosed liabilities that subsequently come to light will be settled by the seller.

### **Yield**

This is calculated by dividing the gross dividend by the share price and is expressed as a percentage. It shows the annual return on an investment from interest and dividends, excluding any capital gain element.





# Useful links

---



**British Venture Capital Association (BVCA)**

[www.bvca.co.uk](http://www.bvca.co.uk)

**European Private Equity & Venture Capital Association (EVCA)**

[www.evca.com](http://www.evca.com)

**The Centre for Management Buy-Out Research**

[www.cmbor.org](http://www.cmbor.org)

**Unquote magazine**

[www.unquote.co.uk](http://www.unquote.co.uk)







# Notes

---



# PKF office list

## **Birmingham**

New Guild House  
45 Great Charles St  
Queensway  
Birmingham B3 2LX  
Tel 0121 212 2222  
Fax 0121 212 2300

## **Bristol**

Pannell House  
6-7 Litfield Place  
Clifton  
Bristol  
BS8 3LX  
Tel 0117 906 4000  
Fax 0117 974 1238

## **Cardiff**

18 Park Place  
Cardiff  
CF10 3PD  
Tel 029 2064 6200  
Fax 029 2064 6201

## **Derby**

Century House  
St James's Court  
Friar Gate  
Derby  
DE1 1BT  
Tel 01332 372936  
Fax 01332 371449

## **Edinburgh**

17 Rothesay Place  
Edinburgh  
EH3 7SQ  
Tel 0131 225 3688  
Fax 0131 225 6017

## **Glasgow**

78 Carlton Place  
Glasgow  
G5 9TH  
Tel 0141 429 5900  
Fax 0141 429 5901

## **Great Yarmouth**

141 King Street  
Great Yarmouth  
Norfolk NR30 2PQ  
Tel 01493 842281  
Fax 01493 330075

## **Guildford**

Pannell House  
Park Street  
Guildford  
Surrey  
GU1 4HN  
Tel 01483 564646  
Fax 01483 578880

## **Ipswich**

16 The Havens  
Ransomes Europark  
Ipswich  
Suffolk  
IP3 9SJ  
Tel 01473 320700  
Fax 01473 320800

## **Leeds**

Pannell House  
6 Queen Street  
Leeds  
LS1 2TW  
Tel 0113 228 0000  
Fax 0113 228 4242

## **Leicester**

Pannell House  
159 Charles Street  
Leicester LE1 1LD  
Tel 0116 250 4400  
Fax 0116 285 4651

## **Lincoln**

St Hugh's  
23 Newport  
Lincoln LN1 3DN  
Tel 01522 531441  
Fax 01522 510185

## **Liverpool**

5 Temple Square  
Temple Street  
Liverpool L2 5RH  
Tel 0151 237 4500  
Fax 0151 237 4545

## **London**

Farringdon Place  
20 Farringdon Road  
London  
EC1M 3AP  
Tel 020 7065 0000  
Fax 020 7065 0650

## **Lowestoft**

19-21 Surrey Street  
Lowestoft  
Suffolk  
NR32 1LP  
Tel 01502 574663  
Fax 01502 514620

## **Manchester**

Sovereign House  
Queen Street  
Manchester M2 5HR  
Tel 0161 832 5481  
Fax 0161 832 3849

## **Norwich**

Cedar House  
105 Carrow Road  
Norwich  
Norfolk  
NR1 1HP  
Tel 01603 615914  
Fax 01603 661626

## **Nottingham**

Regent House  
Clinton Avenue  
Nottingham  
NG5 1AZ  
Tel 0115 960 8171  
Fax 0115 960 3665

## **Sheffield**

Knowle House  
4 Norfolk Park Road  
Sheffield S2 3QE  
Tel 0114 276 7991  
Fax 0114 275 3538

## **Associated firms**

### **Guernsey**

P.O. Box 296  
Suites 13&15  
Sarnia House  
Le Truchot  
St Peter Port  
Guernsey GY1 4NA  
Channel Islands  
Tel 01481 727927  
Fax 01481 710511

### **Isle of Man**

P.O. Box 16  
Analyst House  
20-26 Peel Road  
Douglas  
Isle of Man IM99 1AP  
Tel 01624 652000  
Fax 01624 652001

### **Ireland**

#### **Birr**

Birr Technology Centre  
Birr  
Co. Offaly  
Tel: 00 353 509 25662  
Fax 00 353 509 25664

### **Dublin**

Trinity House  
Charleston Road  
Ranelagh  
Dublin 6  
Tel 00 353 1 496 5388  
Fax 00 353 1 496 9226