Private Equity

Raising funds for your business

Expert knowledge means success

Contents

Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

Private equity in the UK originated in the late 18th century, when entrepreneurs sought out wealthy individuals to provide financial backing for their businesses. By the early 1980s, a private equity industry was establishing itself in the UK. A number of private equity firms were founded at this time following on from the success of private equity investments in the US.

Private equity is now a recognised asset class and has significantly altered the business landscape over the last 25 years. One in three companies sold today is bought with private equity finance and one in five employees in the private sector is employed by a company owned by private equity investors. In the UK, there are over 170 active private equity firms, which employ around 5,000 people, of which some 3,000 professional executives are active investors. They collectively provide several billion pounds annually to unquoted companies, of which around 80% (1,300 businesses) are located in the UK.

There have been many high profile investments recorded in the media where private equity firms have invested in companies listed on public exchanges and taken them private: such acquisitions include the purchase of AA by Permira and the purchase of Debenhams by a consortium of private equity firms. This proved a very successful strategy in the above mentioned acquisitions and reaped hundreds of millions of pounds in rewards for the private equity investors involved.

The UK private equity industry is now the largest and most dynamic in Europe accounting for just over half of the whole European market, and worldwide is second in size only to the United States.

What is Private Equity?

The BVCA defines private equity as "*the equity financing of unquoted companies at many stages in the life of a company from start-up to expansion or even management buy-outs (MBOs) or buy-ins (MBIs) of established companies. 'Venture capital' is a subset of private equity, covering the seed to expansion stages of investment.*"

Put simply, private equity is a way of raising share capital from external investors in return for handing over a share of the business. This may take many forms including a share of future profits but is most frequently associated with sharing the ownership of the business to some degree and sometimes, an element of control of the business.

The media tends to use the term to refer mainly to leveraged buy-outs where a company is bought with borrowed money in the hope of improving profits and selling it on at a higher price.

The key feature of private equity is that the investment funds are not raised through the public markets.

Unlike lenders, private equity investors don't normally have rights to interest or to be repaid at a particular date. Their return is usually paid in dividend payments and depends on the growth and profitability of the business.

Because equity investors share the risks a business faces, private equity is often referred to as risk capital.

Is it right for your business?

Because of the risk to their funds, investors expect a higher potential return than for safer, more secure investments. Private equity is likely to be most suitable:

- where the nature of a project deters debt providers, e.g. banks; or
- where the business will not have enough cash to pay loan interest because it is needed for core activities or funding growth

Questions to ask include:

- Are you prepared to give up a share in your business and some control? Investors expect to monitor progress and many seek involvement in significant decisions.
- Are you and your key people confident in the business' product/service? Does it have a unique selling point that singles it out?
- Do you have the drive to grow the business?
- What industry experience and knowledge does your management team have? Is there a variety of skills?

What is private equity?

Private equity refers to how investment companies raise the funds they use. Instead of going to the stock market and selling shares, private equity companies raise cash from private sources usually borrowing money from banks, or pooling groups of smaller investors in private equity funds.

Private equity companies then often add their own funds and use the money to buy companies that they have identified as underperforming, but with the potential to do far better.

Many of the firms they buy are listed on the stock exchange and are then withdrawn so that the private equity firm can try to turn the business around and sell it on at a future date.

Private equity does for companies what some builders do with houses: they get a big mortgage to buy one, do it up as fast as possible and then re-sell it at a profit.

Source: BBC, June 2007

You should also seek professional advice.

Different forms of private equity suit different business situations. The main sources of private equity in the UK are angel investors that provide smaller amounts of finance at an early stage in a business and venture capitalists/private equity firms who may invest at all stages in a business for example providing venture capital or capital for buy-outs. Corporate venturers - industrial or service companies that provide funds and/or a partnering relationship to early stage companies - can also provide equity capital.

- Business angels can offer investment, particularly in the early or growth stages of development, in return for equity;
- Venture capital is most often used for high-growth businesses destined for flotation on the stock market - with shares available to the general public - or sale.

Respondents to a BVCA survey indicated that in 38% of private equity investments investors provided funds for managers to buy out or buy into their company and in the remaining 62% of cases funds were provided at the start-up to expansion stages.

Business angels and venture capitalists are the most common and appropriate providers of private equity finance for SMEs.

Business Angels

Business angels are wealthy individuals who invest in high-growth business in return for equity. Some business angels invest on their own, whereas others do so as part of a network, syndicate or investment club. In addition to money, business angels often make their own skills, experience and contacts available to the company.

Business angels typically invest in businesses with:

- an investment need of between £10,000 and £250,000 - most initial investments are less than £75,000;
- the potential for high return - business angels are not averse to high risk;
- good early stage development or expansion;
- a presence in a particular sector.

The advantage of using a business angel is that they often make an investment decision quickly, without complex assessments.

However, you will still need to draw up a professional and tailored business plan. Most business angels can bring valuable first-hand experience of either working in a small business or running their own business venture. They're also likely to have local knowledge, as they tend to focus their investments within a small geographical area.

The disadvantage of business angels is that they don't make investments very regularly and may not be actively looking for an opportunity, so they may be difficult to find. While you may decide to approach an agency to help you with this, business angels will place a lot of emphasis on your relationship and how well you can work together directly. Tracking down the right investor may take longer than expected and can typically take several months.

The British Business Angels Association (BBAA) will direct you to local and appropriate business angel networks and provide guidance with preparing and presenting your business proposal. For more information about business angels visit the BBAA website at:
http://www.bbaa.org.uk/

Please ask for our publication:
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Enterprise Capital Funds (now Capital for Enterprise)

In some cases investment funds from a business angel may be matched by the government under its Enterprise Capital Funds (ECFs) scheme. ECFs are commercial funds, investing a combination of private and public money against a share of equity in small high-growth businesses seeking up to £2 million of private equity.

Enterprise Capital Funds (ECFs) address a market weakness in the provision of equity finance to SMEs by using Government funding alongside private sector investment to establish funds that operate within the ‘equity gap’. An equity gap arises where businesses with viable investment propositions are unable to attract investment from informal investors or venture capitalists. In bridging this gap, ECFs aim to alleviate what would otherwise present a significant barrier to enterprise and to productivity growth. Nine such funds have been launched since 2006.

On 1 April 2008, responsibility for the management of ECFs along with the Department for Business, Innovation and Skills' (BIS) other equity funds and the Small Firms Loan Guarantee (SFLG) was transferred to a new body, Capital for Enterprise Limited (CfEL]. This was aimed at improving the selection and management of the funds, but did not change the nature of the funds or their policy objectives.

Additionally, CfEL are now responsible for the management of the Enterprise Finance Guarantee (EFG).

Enterprise Capital funds replace previous products such as the Regional Venture Capital Funds, which are now closed for new applications.

There is an ongoing process for allocation of Government investment in ECFs. Guidance and information for organisations interested in being selected to manage an Enterprise Capital Fund is accessible at the Capital for Enterprise website:
http://www.capitalforenterprise.gov.uk/files/Guidance%20for%20Prospective%20ECF%20Managers%20-%20V2.pdf

Venture Capital

Venture capital is also known as private equity. Unlike business angels, venture capitalists look to invest large sums of money in return for some of your business' shares.

Venture capitalists typically invest in businesses with:

- a minimum investment need of around £2 million, though many smaller regional venture capitalist organisations may invest from £50,000;
- an ambitious but realistic business plan;
- a product or service that provides a unique selling point or other competitive advantage;
- large earning potential and offering a high return on investment within a specific time frame, e.g. five years;
- sound management expertise - although venture capitalists tend not to get involved in the day-to-day running of the business, they often help with a business' strategy;
- a proven track record - for this reason start-ups are generally not considered by venture capitalists for investment.

The advantages of securing a venture capitalist are that they can provide large sums of private equity and bring a wealth of expertise to your business. Also, if you successfully attract a venture capitalist to your business, you're likely to find it easier to secure further funding from other sources.

The disadvantage is that securing a deal with a venture capitalist (VC) can be a long and complex process. You'll be required to draw up a detailed business plan, including financial projections for which you're likely to need professional help. Also, if you get through to the deal negotiation stage, you'll have to pay legal and accounting fees whether or not you're successful in securing funds.

The British Venture Capital Association (BVCA) helps larger businesses locate venture capital companies. For more information about venture capitalists visit the BVCA website at:
www.bvca.co.uk

The European Private Equity and Venture Capital Association (EVCA) provides information and networking opportunities for investors, entrepreneurs and policymakers in the private equity industry. For more information about the private equity industry visit the EVCA website at:
http://www.evca.eu/

The Equity Gap

The equity gap is a term used to explain the gap a company experiences in funding as it moves up the ladder of different finance sources.

For example, some businesses require much greater funding than that which can be provided by business angels, but do not need the levels of funding venture capitalists would consider. The gap between these two finance situations is known as the equity gap. Businesses in this situation may wish to approach private equity firms for help. These are organisations that invest and manage investments and they tend to focus on management buy-outs and buy-ins.

The government provides a multi-million pound equity finance scheme to close the equity gap by providing Enterprise Capital Funds (ECFs).ECFs are commercial funds that invest a mix of private and public money in small, high growth businesses seeking up to £2 million in risk capital. You can find out about ECFs on the Department for Business, Innovation & Skills (BIS) website at: ww.bis.gov.uk/policies/enterprise-and-business-support/access-to-finance/enterprise-capital-funds

In Scotland, Scottish Enterprise runs a number of equity finance initiatives. The Scottish Venture Fund, Scottish Co-investment Fund and Scottish Seed Fund provide equity investment between £20,000 and £2 million to companies with good growth prospects. Find out about Scottish Enterprise investment funds on the Scottish Enterprise website at: http://www.scottish-enterprise.com/fund-your-business/other-sources-of-funding.aspx

Further information on the funding gap can be found on the following website: http://www.equitygap.co.uk/

Advantages and Disadvantages of Private Equity

Private equity can sometimes be more appropriate than other sources of finance, e.g. bank loans, but it can place different demands on you and your business.

Advantages

The main advantages of private equity are:

- The funding is committed to your business and your intended projects. Investors only realise their investment if the business is doing well, e.g. through flotation or a sale to new investors;
- Resources for your business. The right business angels and venture capitalists can bring valuable skills, contacts and experience to your business and can assist with strategy and key decision-making;
- In common with you, investors have a vested interest in the business' success, i.e. its growth, profitability and increase in value;
- Investors are often prepared to provide follow-up funding as the business grows.

A key benefit of private equity funding over traditional bank loans is that the returns to the private equity firm are intrinsically linked to the business' growth and success. It faces the risk of failure just like any other shareholder. The more successful the company is, the better the returns all investors will receive. If the business is struggling, the private equity firm is financially incentivised to work hard to ensure that the company is turned around. If the business fails, private equity investors will rank after banks and other lenders and could lose their investment.

Most of the private equity investors reward is realised as a capital gain through an "exit" which may include floating the company on a stock market, selling their shares back to the management or selling their shares to another investor for example another private equity firm or company.

Where private equity is used to take a public limited company private, the company is released from appearing a potentially short-term focussed shareholder base and may be more able to take strategic long-term decisions.

Disadvantages

The principal disadvantages of private equity are:

- Raising private equity is demanding, costly and time-consuming. Your business may suffer as you devote time to the deal. Potential investors will seek background information on you and your business, they will closely scrutinise past results and forecasts and will probe the management team. However, many businesses find this discipline useful regardless of any funding;
- Depending on the investor, you will be subject to varying degrees of influence over the management of your business and making of major decisions;
- You will have to invest management time to provide regular information for the investor to monitor;
- Your share in the business will be diluted. However, your share may be of a much larger business because of the funding;
- There can be legal and regulatory issues to comply with when raising finance, e.g. when promoting investments.

Securing Private Equity – Tips for the Smaller Business

The preparation

If you've decided to seek private equity, you'll need a comprehensive business plan incorporating a detailed marketing plan and realistic financial projections.

Consider the following issues:

- how much funding you need and for what purpose;
- how much control you're hoping to retain and the skills the business needs;
- how long you need the funds for.

Any potential investor will be looking for a number of core issues in your business plan:

- What are your funding needs?
- Are your plans for the business realistic?
- Is your venture appropriate for external investment?

Your business plan should seek to address these issues and you should tailor the information you provide according to the investor you're approaching. The plan should include a series of detailed financial forecasts, what you intend to do with the funding, how you'll repay the investor, your management's level of expertise and what the investor can expect in return.

Approach short-listed investors directly through an introduction or contact, or their association or network. Remember that many private investors are interested in specific industry sectors or geographical regions, so make sure your shortlist only includes suitable candidates.

Networking is an important way of finding investors, and it may be a good idea to find suitable candidates through recommendations from your specific industry or their associated network. Go to events organised by your local Business Link and Chamber of Commerce in order to introduce yourself to people and get your business known to potential investors.

The British Business Angels Association provides advice on how to find business angels on its website at: www.bbaa.org.uk.

Similarly, the British Venture Capitalist Association provides advice on how to find venture capitalists on its website at: www.bvca.co.uk.

The pitch

Pitching your plan or proposal to potential investors may have and show the benefits of their involvement. Emphasise:

- the investment required;
- the terms you're proposing – e.g. share of control, skills, timescale of investment;
- the ability of the management team to proceed with the plan.

You need to decide who will undertake the actual presentation and whether, for example, you want to involve the whole management team. You can help to create a professional pitch by dressing smartly and ensuring that basic business etiquette is kept, e.g. punctuality. Deciding the style and length of the presentation is also important. Keeping it short, catchy and appropriate to your audience may impress more than a long-winded, complex presentation.

If the potential investor is interested in collaborating with you, you can start negotiating key issues in detail, e.g. respective responsibilities, growth targets, the investor's exit strategy, service contracts, warranties and indemnities. You should also specify how the investment relationship will be managed and what involvement they'll have in the company.

Provide detailed, credible and professionally presented information, such as historical and forecast financial information, business policies and procedures and customer and supplier details, for the investor to scrutinise.

If your pitch is successful you'll need to draw up a plan of how the investor will fit into the way you manage your business. Some investors may be more of a "sleeping partner" in your business, while others may want to be actively involved in the management of your business. You won't have to give up day-to-day control of your business, but you'll need to negotiate with your investors at what level they get involved. Remember that most investors may not just be offering cash to your business, but also their expertise.

Management Buy-outs/Buy-ins

Private equity firms invest at all stages of a business' development. In addition to growth and expansion capital, private equity firms may provide replacement capital to free up personal wealth without selling the business outright or funding for a management buy-out by the existing management team or a management buy-in by a management team from outside the business. Recent media coverage has focussed on the role of private equity firms in leveraged buy-outs.

Private equity firms raise capital from institutional investors and wealthy individuals who invest in private equity funds, which are in turn used by the firms for investment in target companies. Some funds may specialise in particular industry sectors or in a particular type of private equity investment such as leveraged buyouts. Where a fund takes a controlling stake in a company, it may bring in a new management team tasked with making the company more valuable.

A typical buy-out opportunity for a private equity firm would be one where a company is aiming to grow rapidly to a considerable size and can offer the prospect of significant turnover growth within five years. Figures from the BVCA suggest that the majority of private equity backed companies are medium-sized and fast growing, with average sales revenue of just over £46 million and an average labour force of 600 staff in the UK.

Private equity firms often work in conjunction with banks and other lenders to fully fund an acquisition. In recent years, there have been many high-profile cases where private equity firms have used a combination of their own private equity fund and debt to buy-out "high-street name" companies which they feel are underperforming. The company is, in effect, taken private and re-launched on a stock-exchange at a profit within three to seven years. The well publicised high levels of debt used for such acquisitions has brought the industry some criticism and City experts including some of the banks that lend to the private equity firms have raised concerns about the levels of debt being taken on in light of rising interest rates.

This type of deal has led the media to portray private equity firms as just buying companies at a cut down price, stripping the assets and reselling the companies making outrageous profits in the process. The speed with which Debenhams returned to the market – just over two years – and the 200% return on investment has done little to help this image. Criticism has also been laid by the unions: the GMB union publicly branded the private equity firm Permira "buccaneering asset-strippers" after the AA dismissed over a quarter of its staff while under Permira's ownership.

Concerns have also been raised over transparency of information as the "taken private" company is shielded from the information requirements levied on public companies. In response to concerns over transparency the BVCA announced in March 2007 its intention to establish a review of transparency and disclosure in the private equity industry with a view to forming a voluntary code or set of guidelines on a 'comply or explain' basis.

Alternative Funding Strategies

Private equity may not suit your business. For example, you may not feel happy about losing a degree of control, or the intended project may be too small to be an attractive investment opportunity.

In these cases, consider the following alternatives:

- Loans - there are many options available, from commercial mortgages secured against your business assets to short-term borrowing for periods of between three and five years. It's probably best to approach your own bank first, but do not overlook other lenders. Speak to us about our publications or advice on loans, overdrafts and commercial mortgages;
- Overdrafts - overdrafts can be expensive but are a flexible form of borrowing. They're not especially suitable for long-term finance as they are repayable on demand;
- Loans from family and friends - these can be a sound method of raising finance but beware of potential damage to relationships if the money isn't repaid on time.
- Additional funds - from you or your fellow partners/directors.
- Government support
- Joint ventures - these can take many different forms. The term normally

applies to the co-operation of two or more individuals or businesses in a specific enterprise rather than in a continuing relationship.

Useful Links

British Business Angels Association
Tel: 0207 089 2305
Website: http://www.bbaa.org.uk/

British Venture Capital Association
Tel: 0207 025 2950
E-mail: bvca@bvca.co.uk
Website: http://www.bvca.co.uk

The European Private Equity and Venture Capital Association
Tel.: +32 2 715 00 20
E-mail: evca@evca.com
Website: http://www.evca.eu/

Business Link
http://www.businesslink.gov.uk

Further Information

This publication is for general interest - it is always essential to take advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

Important Notice

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