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Private Equity: a Practical Guide

Abstract: The purpose of this article, by Stephanie Biggs of Kirkland & Ellis International LLP, is to give an introduction to private equity. The article provides a brief overview of the industry, then looks in more detail at the two key processes in which private equity lawyers are involved: fundraising and doing deals. The author also looks at the resources available for researching private equity and provides a glossary of commonly used terms.
Keywords: private equity; information resources

What is private equity?

Private equity is, fundamentally, about investing in companies. Companies need money to develop and grow. Sometimes this money comes from the company itself – the company makes profits, and reinvests those profits in the business. However, this is not always enough.

If the company requires additional funds, it will need to find an external investor who is willing to put money into the company. In theory, the company could seek to raise money by offering its shares to the general public through listing its shares on a stock exchange. In practice, this is not an option for a small, unknown company, so it will turn instead to private individuals or organisations with money to invest. Firms that specialise in the provision of capital to unlisted companies are known as "private equity firms".

It is rather like the BBC television programme *Dragon's Den*. An entrepreneur invents a product that could potentially make a lot of money, but can't afford to buy the machinery and equipment needed to make the product, or to employ a sales force to sell it.

The entrepreneur could raise the extra money by taking out a bank loan. However, banks are relatively risk-averse, and may not be willing to lend money to a new, untested company. If the entrepreneur cannot persuade the bank to make a loan – or to make a big enough loan – he will need to find an alternative source of finance.

The Dragons have money, and also business experience and contacts. So, the entrepreneur goes to the Dragons and asks them to invest in the company. If a Dragon decides to invest, his money will enable the product to be produced and sold. The Dragon's business experience will also help the product to succeed. For example, he is likely to have more experience of finance, management or marketing than the entrepreneur, and may have useful contacts with potential suppliers or customers. The Dragon, of course, expects something in return for his or her investment. The return is an ownership stake, known as a share of the "equity", in the entrepreneur's company.

Equity versus debt

The key differences between an equity investment and a bank loan (generally referred to as "debt") are:

- The level of risk.
- The potential level of return.

If a company takes out a bank loan, it will have to repay the amount borrowed, together with interest, from the money that it makes by selling the product. The company must repay the bank before the owners of the company get any money at all, which reduces the level of risk for the bank. However, the bank's return will never be more than the agreed rate of interest, even if the product is a huge success.

In contrast, where an investor takes an equity stake, it will be entitled to a share of the money that is left after the company has paid its expenses (the costs of producing the product, plus overheads such as salaries and rent) and any debts (such as bank loans). If the product is a huge success, the investor may make a lot of money. The risk, of course, is that the product is not a success, in which case there may be no money left after the company has paid its debts, and the investor may lose its whole investment. This is why an equity investment is sometimes described as "risk capital".

Private equity firms are professional "Dragons", making investments in companies in return for equity stakes.

Public versus private

An entrepreneur seeking to start up or grow a business may need an investment of only a few hundred thousand, or a few million pounds. This is commonly called "growth capital" and private equity investors specialising in this type of investment are generally known as "venture capitalists". At this end of the scale, the venture capital firm will typically take only a minority stake in the company, leaving the entrepreneur with overall control of the business.

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However, venture capital is only one part of private equity. Well-established companies may also need to raise money from private equity investors. For example:

- The founders of a large, successful family business may want to take out their capital and retire by selling their stake in the company to a private equity investor.
- A company may have ambitious expansion plans that are too costly to finance from profits, so it may raise the money needed from a private equity investor.
- If a multinational is looking to sell a company within its group that is not central to its main business (known as "divesting non-core assets"), the managers of that company may want to buy it and run it for themselves but, as individuals, they are unlikely to have sufficient capital and so will need to team up with a private equity investor to make the acquisition (this is known as a "management buy-out").

In these larger transactions, the private equity firm will almost always seek full control of the company, with a relatively small percentage of the shares being offered to the management team as an incentive to make the company a success.

At the very top-end of the scale, a company may also have the option of raising money by listing its shares on a stock exchange. This can be a good source of finance, but has certain drawbacks:

- It is expensive to obtain and maintain a stock exchange listing.
- A listed company has to comply with extensive corporate governance requirements to ensure that it is properly run for the benefit of its shareholders.
- The directors of the company may feel unable to take a long-term view, as the public market may not accept a period of underperformance while a long-term plan is put into effect.
- The company is often subject to extensive scrutiny, not just from shareholders, but also from the media.

In some cases, it may be possible to run a company more efficiently and more profitably as a private company than as a public company. If this is the case, a private equity investor may launch a takeover bid to acquire and de-list the company. This type of transaction is known as a "public-to-private", "P2P" or "take private", and can run into hundreds of millions, or even billions of pounds.

The private equity firm

A private equity firm generally invests other people's money. Typically, the private equity firm will raise a private equity fund to provide the money for making investments. The investors in these funds will be institutions with large amounts of money to invest, such as pension funds, insurance companies or government agencies.

The private equity firm will charge these investors a management fee, and will also take a share of the fund's profits if the investments perform well. So, why do institutions invest through private equity funds, rather than simply making investments themselves?

There are two main reasons:

- Expertise.
- Diversification of risk.

Expertise

To make a successful private equity investment, you need to be able to:

- Identify those companies that may be looking for, or suitable for, investment.
- Assess whether a company is a good investment prospect or a bad investment prospect.
- Provide strategic and operational know-how to the company to make it more efficient and so more profitable (although the management team will run the company on a day-to-day basis).
- Improve the company's capital structure, by making the most effective use of bank finance.
- Sell your shares in the company to someone else at a profit.

This requires a level of expertise that investors may not possess. As a result, many investors prefer to invest through a private equity firm.

Diversification of risk

As described above, a private equity investment is a high-risk investment. Some businesses will succeed spectacularly, but others will fail. Consequently, it makes sense to build a portfolio of investments, so that any losses on unsuccessful investments are (one hopes) outweighed by the gains on successful investments.

A single investor – even a large institutional investor – is unlikely to have sufficient capital to build a fully diversified portfolio on its own account. A private equity firm offers an investor the opportunity to pool its resources with other investors by investing through a fund (sometimes described as a "pooled investment vehicle" or a "collective investment scheme"). This reduces each investor's exposure to individual investments, and so reduces investment risk.

Forming a private equity fund

Private equity funds may be differentiated by stage and/or size of investment (venture capital, mid-market buyout, leveraged buyout), geographic focus (the United States,

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Western Europe, the emerging markets) or sector focus (retail, hotels, leisure, telecoms). Depending on their own area of expertise, and based on their assessment of the market, the private equity executives will decide what type of fund to raise.

The private equity firm will then produce a document (known as an "information memorandum" or "private placement memorandum") explaining the fund's investment strategy and approach, and the key commercial terms on which investors will invest. The PPM will be sent out to a number of prospective investors, and the private equity firm will often also hold roadshow presentations and/or have face-to-face meetings with potential investors. If an investor indicates that it is interested in making an investment, it will receive a full pack of legal documentation for review.

In general, private equity funds are structured as limited partnerships, as these vehicles have commercial and tax advantages. The commercial deal between the private equity firm and the investors is encapsulated in the constitutional document of the limited partnership, known as a "limited partnership agreement". Unlike investment products designed for retail investors, the terms of investment are not necessarily fixed, and investors may want to negotiate both commercial and legal terms.

Once the limited partnership agreement has been finalised, the fund will hold what is known as a "closing". At closing, prospective investors commit to invest a certain amount (known as their "commitment") in the private equity fund. As soon as the fund has "closed", investors are contractually bound, although they won't hand over any money until the fund has an investment to make.

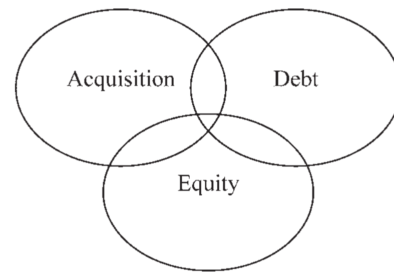
The private equity firm can now go out and do deals…

Doing deals

First, the private equity firm needs to source a good investment opportunity. When it has identified a company that looks interesting, it will carry out a "due diligence" investigation (with assistance from professional advisers, such as lawyers and accountants) to ensure that it can make a fully informed investment decision. This involves taking a detailed look at the records of the company, such as accounting records and key legal and contractual documents, to decide whether the investment is worth pursuing and, if so, what price should be offered.

If the private equity firm decides to make the investment, it will offer to buy the company. What happens next depends on the type of transaction in question (venture capital deals, in particular, have different characteristics), so this article will focus on the most common scenario – the management buyout.

From the lawyer's perspective, a management buyout transaction is like completing three deals in one.



Acquisition

First, the private equity fund must acquire the target company. This transaction is much like any other corporate M&A deal. The key document is the share purchase agreement, which sets out the terms on which the private equity fund will acquire the company from its current owners.

Debt

Often, the acquisition will be leveraged, meaning that the acquisition of the target company will be financed partly through debt (that is, by taking a loan from a bank or other debt provider). The use of leverage makes the private equity fund's resources go further and – in the right economic climate – can significantly enhance returns to investors. If this is the case, the private equity fund will need to negotiate the terms on which it will borrow from the lenders. The key document for this element of the transaction is the facility agreement.

Equity

Finally, the private equity fund will need to negotiate the terms on which the management team will invest in the company. This is seen as a critical element of the transaction. For the investment to succeed, the management team need to be motivated to work hard and produce results. This is achieved by giving management an ownership stake in the business, which will make them wealthy individuals if the company is a success. The key document here is the shareholders' agreement (sometimes called an investment agreement), which sets out the deal between the private equity fund and the management team.

All three pieces of the jigsaw are critical to the deal, and all three elements of the transaction must complete simultaneously.

Exit

Exit, or the sale of the portfolio company, is perhaps the most important step in the cycle. The purpose of a private equity fund is to produce returns for investors. This can only be achieved if the private equity fund can sell its portfolio companies within a reasonable timeframe (usually three to five years after acquisition), and for a significant uplift in price.

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Exit will usually be achieved by selling the company to a trade buyer, such as a competitor, or to another private equity investor or, in some cases, by floating the company on the stock exchange. At this point, the private equity firm will be looking to raise a new fund to invest, and the cycle begins again.

Researching private equity

For the legal information professional, private equity can be a difficult area to research. There are few textbooks or articles, and practitioners tend to rely heavily on their own market knowledge and experience. In addition, private equity is, by nature, an innovative and fast-moving industry, so information can become out of date very quickly.

There are a number of useful resources available, primarily online, and some commonly used websites are highlighted below. Please note that some of these sites (or certain content on some of these sites) are available only to members or subscribers.

Practical Law Company (www.practicallaw.com)

A section of PLC's corporate service is dedicated to private equity and management buyouts, and includes practice notes and standard documents.

*British Private Equity and Venture Capital Association (*www.bvca.co.uk*)*

The BVCA is the industry body for the UK private equity and venture capital industry. The BVCA website includes a number of useful resources (some restricted to members only), including industry data, guidance notes, model documents and legal and technical bulletins. The website also includes the industry standard valuation and reporting guidelines.

*European Private Equity and Venture Capital Association (*www.evca.com*)*

EVCA is the European industry body for private equity firms. The EVCA website is useful for pan-European facts and figures, and includes EVCA's responses to European Commission consultations. EVCA has produced a number of industry standards, which are available from its website, and the website also has an extensive and easy-to-use glossary.

*Europa (*www.europa.eu*)*

Tucked away in the depths of Europa are two useful sites in relation to EU policy and regulation (but bookmark them, as they aren't easy to find!). The sites are:

The European Commission (Internal Market) Investment Funds microsite http://ec.europa.eu/internal_market/investment/index_en.htm

The European Commission (Enterprise and Industry) Investing Across Borders microsite http://ec.europa.eu/enterprise/entrepreneurship/financing/investing_across_border.htm

*Financial Services Authority (*www.fsa.gov.uk*)*

The FSA website is a key resource for financial services lawyers advising private equity firms on regulatory matters. Particularly useful as an introduction to the private equity industry is the discussion paper published by the FSA in November 2006 (DP06/6: Private equity: a discussion of risk and regulatory engagement) and the related feedback statement published in June 2007, which are both available in the online FSA Library.

*The Guidelines Monitoring Group (formerly the Walker Working Group) (*www.walker-gmg.co.uk*)*

The Guidelines Monitoring Group is an independent body that was set up as a direct result of Sir David Walker being asked by the BVCA and a group of major private equity firms to undertake an independent review of the adequacy of disclosure and transparency in private equity. The consultation paper issued by Sir David Walker, and the resulting Guidelines for Disclosure and Transparency in Private Equity can be downloaded from this website.

*AltAssets (*www.altassets.com*)*

The AltAssets website is an online news and information service targeted at institutional investors. It is published by Almeida Capital, a placement agent and private equity advisory firm. A free weekly newsletter is available by email, and the "Knowledge Bank" section of the website has an extensive selection of articles on hot topics.

*Private Equity Intelligence (*www.prequin.com*)*

Private Equity Intelligence is a subscription-only service, but its monthly *Spotlight* newsletter has some useful articles and is available free.

*Private Equity Online (*www.privateequityonline.com*)*

Again, most content is restricted to subscribers, but the *Friday Letter* highlighting the week's key developments can be downloaded without a subscription.

Glossary

In order to research private equity effectively, it is necessary to be familiar with a significant amount of technical terminology. A glossary of commonly used terms is set out below.

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Carry holder	A private equity executive who has a right to share in the **carried interest**. The proportion of the **carried interest** received by any individual executive will usually depend on seniority and performance.
Carried interest or Carry	A performance incentive for private equity executives. If a private equity fund performs well, the executives will receive a share (usually 20%) of the profits made by the fund. The right to receive these profits is known as the **carried interest** or **carry**.
Co-investment	Investing alongside another investor. This term is used in a variety of contexts. Generally, it refers to a private equity fund offering a proportion of an investment opportunity to a third party (a "Co-investor"). It is also used in relation to a private equity firm investing its own money alongside the investors in its fund (see "GP Commitment") or, where a private equity fund is structured as a series of parallel vehicles, the arrangements under which the parallel vehicles invest together.
Founder partner	A special purpose vehicle formed by the private equity executives to receive the **carried interest**. Also known as the **carry partner** or **special limited partner**.
Fund closing	The formal admission of investors to a private equity fund. This is the point at which an investor becomes contractually bound.
General partner ("GP") or Fund manager	In general, another way of referring to the private equity firm. The term **general partner** derives from the partnership structure typically used when establishing a private equity fund. Sometimes used in a strict, technical sense.
General partner's share ("GPS")	Another way of describing the management fee paid to the private equity firm by investors in a private equity fund. The term derives from the fact that, for tax reasons, the private equity firm often receives these amounts as a profit share paid to the **general partner** of the fund partnership and not as a fee.
GP commitment	The amount of money (usually 1% or more of the amounts invested by third party investors) that the private equity firm is required to invest in its own funds. Also known as the **GP co-invest** or **GP co-investment.**
Institutional buyout ("IBO")	Where a private equity firm independently acquires a company as an investment, after which the existing or new management are given an ownership stake.
IPO	An initial public offering of shares in a portfolio company. Also known as a **flotation, listing** or **going public**.
Leveraged buyout ("LBO")	Where a private equity firm funds the acquisition of a company using a significant amount of debt in addition to money from its own fund.
Limited partner ("LP")	In general, another way of referring to an investor in a private equity fund. The term derives from the partnership structure typically used when establishing a private equity fund. Sometimes used in a strict, technical sense.
Management buyout ("MBO")	Where a company's management team buy the company they work for from its current owners with private equity backing.
Portfolio company	A company invested in by a private equity fund. Also sometimes referred to as an **investee company**.
Preferred return	The rate of return (usually 8% per annum) that a fund must achieve for its investors before any **carried interest** is payable to the private equity executives. Also known as the **hurdle**.
Private equity	The provision of medium to long-term finance to companies in return for an equity stake.

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Private equity executives	The individuals who work for a private equity firm.
Public to private	Where a private equity firm acquires a listed company and takes it into private ownership. Also known as a **take private** or **P2P**.
Secondary buyout	Where a private equity firm acquires a company from another private equity investor.
Start up capital	An investment made early in the life of a company to fund product development and initial marketing.
Tertiary buyout	Where a private equity firm sells a portfolio company acquired by way of a **secondary buyout** to another private equity investor.
Trade sale	Where a private equity fund sells a portfolio company to a trading company (often a competitor, supplier or customer of the portfolio company), rather than to another investor.
Venture capital	Sometimes used synonymously with **private equity**, but generally used to mean making private equity investments in companies that are still at an early stage of development.

Biography

Stephanie Biggs is a professional support lawyer in the London office of Kirkland & Ellis International LLP.

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Sources of Company Information in the UK

Abstract: Janice Edwards of Maclay Murray & Spens provides a brief guide to sources of both primary and secondary company information.
Keywords: companies; information resources

Primary company information

This consists of the following:

Registered company details

This is the full name and address of a company and list of officers and directors, known as the **Annual Return**.

http://www.companieshouse.gov.uk/ – The Webcheck service offers this information free of charge for companies trading in England, Wales, Scotland and Northern Ireland.

There are commercial sites which offer all or some of this information free of charge, e.g. www.hemscott.com, or on an account or PAYG basis, e.g. www.icc.co.uk

The London Stock Exchange offers this information free of charge on its Investor Centre web pages http://www.londonstockexchange.com/en-gb/pricesnews/

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