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Excerpt
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1 An introduction to private equity

1 Introduction

In this chapter we aim to provide a general introduction to private equity as it has been practised in the United Kingdom in the period up to January 2009. We will introduce some of the key players that shape the market and the types of deals that they do. This chapter will help to explain how private equity evolved into what it is today and will look at some of the factors that may influence its future. It is designed to set the scene for much of the rest of this book, and to give to the reader who is less familiar with the sector a welcome overview of a typical deal and some of the bigger issues in the private equity marketplace generally, but with a particular focus on the UK mid-market.

Industry terminology exists in all markets and has its place as shorthand for those familiar with the territory. Ever more colourful and elaborate phrases and acronyms are coined. In the private equity market they have (or once had) distinct and separate meanings and nuances. Many are now merging and being used inconsistently, creating an aura of spin and shimmer around the sector, and meaning different things to different people. We will seek to demystify some of the features of the market and the jargon used by practitioners and commentators alike.

This chapter will set out some of the history of the industry and explain the key building blocks with which it has been built. One of these, as we will see, is the focus on the Business Plan. We will go on to consider the significance of the Business Plan in a private-equity-backed transaction, and the ways in which such Business Plan will be assessed by investors to underpin their desired financial returns. In particular, we will look at how management and their advisers put together the Plan, and what factors are of particular interest to private equity funders in the evaluation of the opportunity, including the types of businesses most likely to attract support. We will also explain the importance of the financial return to private equity and some of the ways in which this can be measured.

Much of this may sometimes seem very technical, especially for a reader who does not deal every day in the world of net present values, discount rates and internal rate of return (IRR). However, it matters – knowing what good and bad looks like in the eyes of many private equity investors can be key to understanding how they value potential investments, how they behave on acquisitions and on exits, and how they react to underperformance. It can help you work with them, knowing what buttons to press (and what buttons to leave untouched), and predicting how they may react in any likely scenario. It can also help in negotiations against them where this is in your own, or your client's, commercial interests.

2 Background to private equity in the UK

2.1 What is private equity?

The term 'private equity' is a generic expression for investments in equity securities in companies which are not listed on any public stock exchange. Generally in the UK this means shares in limited companies, although there are exceptions (such as so-called 'vanity plcs', being public limited companies which are not listed on any investment exchange, but maintain plc status in order that the term 'plc' may be used in the corporate name).[1]

There is a wide range of types and styles of private equity, and the term therefore has different connotations depending on the circumstances (and possibly jurisdiction) in which it is used. In the UK, as for most other developed economies, the expression is generally used to describe any type of transaction whereby a fund or group of funds invests monies either directly into an operating company, or for the purposes of acquiring a company or group of companies (for ease of reference, referred to throughout this book as the 'Target'). Funds may be provided from a wide range of sources including pension funds, financial institutions and other institutional investors, companies, public bodies and high net worth individuals (for more on the different types of private equity funders in the UK market see section 2.3 below).

There are many different types of private equity transaction in the UK. Unfortunately, different expressions are sometimes used interchangeably and inconsistently, which can cause confusion. The following labels are most regularly encountered:

(a) Management buyouts (MBOs, or buyouts)

This phrase is generally used to describe the acquisition of a company (Target) by its incumbent senior management team, who up until the time of the buyout may have held either a limited equity stake, or no shareholding at all. MBOs may arise for a variety of reasons, the most usual being a corporate holding

1 There are implications to being a vanity plc rather than a private company. For example, a public limited company must satisfy particular minimum share capital and other requirements set out in sections 4(2) and 761–767 of the Companies Act 2006, and a vanity plc will be subject to the requirements of the City Code on Takeovers and Mergers notwithstanding that it is not listed.

company disposing of a non-core subsidiary, or one or more private sellers looking to unlock the value in their company (e.g. where there is no obvious successor to inherit a family business). Traditionally, such transactions were often sourced by the management teams themselves, who then took the Target business to the market for funding through retained advisers; however, as the private equity industry developed, it became more common for private equity firms to approach the Target, or for the seller(s) concerned to instigate the transaction, with management involvement being minimised until later in the process (see section 2.4 below).

(b) Management buyins (MBIs)

An MBI is identical to an MBO save that the management team that will invest alongside the private equity funds, and run the Target business, has not previously been involved in the management of the Target. The lucrative profits earned by management teams from successful MBOs led to many individual managers researching their own industry sectors, with a view to identifying potential acquisition targets which they could then run with a deal funded by private equity. Individuals who have previously been successful in an MBO often then move on to look for MBI opportunities.

A 'pure' MBI (i.e. where there is no involvement of any member of the management team within the existing business) is now rare in the UK. The lack of any inside knowledge of the Target business means that there is an increased risk to the funders of the transaction; even where a comprehensive due diligence exercise is carried out by external accounting, legal and other advisers, there is no substitute for experience from within the business. As a result, many private equity funders refuse to contemplate MBIs at all.

That said, on a buyout, the existing management team is often complemented by one or more managers from outside the business. In many modern deals in the UK, the team will include a combination of the existing management team and managers from outside the company; such transactions are sometimes referred to as 'buyin management buyouts' (or, affectionately, BIMBOs) – although such deals are often still simply referred to as MBOs or buyouts.

(c) Leveraged buyouts and institutional buyouts (LBOs/IBOs)

The expression 'leveraged buyout', or LBO, is used to describe a buyout where significant debt is utilised by the private equity firm in order to fund the acquisition of Target. The expression originates in America, although it has been used more extensively in the UK market in recent times (particularly as a consequence of the buyout boom between 2005 and 2007 – see section 2.2).

In reality, leverage is used to some degree by private equity firms in all buyouts to deliver the returns that their ultimate funders expect. In chapter 3, a typical deal structure is outlined demonstrating how bank debt (and, indeed, debt investment by the private equity investor) is combined with a relatively small (often, therefore, described as 'pinhead') equity investment. In the UK, therefore, whilst the expression LBO may generally be applied to any buyout, its use tends to be limited to those buyouts with particularly high levels of leverage – often involving several layers of debt funding, as is described in more detail later in this book.[2]

Another expression often used is 'institutional buyout', or IBO. This expression simply describes a transaction where the private equity investors are leading the acquisition process and will hold a substantial majority interest in the buyer vehicle (with the management team holding a relatively small, minority interest). In these cases, the relevant private equity firm or firms are often referred to as 'sponsors'. The terms LBO and IBO often go hand in hand because, as a general rule, as the deal size increases, it is far more likely that significant leverage will be required and that the transaction will be structured as an IBO with majority control in the hands of the private equity investors.

(d) Venture capital

In the UK, the terms 'venture capital' and 'private equity' have often been used interchangeably, causing some confusion. Indeed, the principal trade body for private equity in the UK, the British Venture Capital and Private Equity Association, was simply the British Venture Capital Association until as recently as December 2008, and is still known in its abbreviated form as the BVCA.

However, the term 'venture capital' is now generally used to describe those transactions where private equity firms invest in less mature companies to assist with the development, expansion or start-up of a business. By its nature, venture capital is often found in the technology, biotechnology, healthcare and pharmaceuticals sectors, although its application is not exclusively limited to those areas. Venture capital funding provides much-needed capital to entrepreneurs who would not otherwise have the funding to invest in the development of important products or exciting new business ideas. For this reason, it is often presented as a 'friendlier face' of private equity.

The legal documentation in a venture capital transaction is similar to that required for a buyout, but there are some differences both in form and in structure. Investment agreements typically provide for phased investments once certain milestones are achieved, for example, whilst a buyout typically requires the investors to commit all of their funds to pay the purchase price to the seller(s) on completion of the relevant acquisition. The forms of investment may also vary, with complex provisions to deal with the possibility of dilution on future funding rounds and to provide investors with a priority return on their investment (usually expressed as a multiple of the amount initially invested) before any proceeds are shared with management. This reflects the riskier nature of venture capital – it is far more likely that a venture will fail

2 See chapter 3, section 2.4, and chapter 6, section 6.

and all, or substantially all, of the initial investment will be lost. Equally, however, when a venture capital investment is successful, the returns can be spectacular, and as such it remains an attractive asset class to investors.

(e) Growth capital and development capital

The expression 'growth capital' is generally used to describe investments in relatively mature companies which require funds for future growth and expansion. The expression 'development capital' is also widely used, and can sometimes describe the same situation, although the latter expression is perhaps associated with businesses that have gone past an initial venture or start-up capital phase, but which are still relatively small, whilst the former can be used to describe deals involving extremely mature businesses. Growth capital funds may also finance a restructuring, for example to reduce high leverage that may be a relic of an earlier buyout, or to give an individual shareholder the ability to extract some cash value from his business, as well as for the purpose of funding significant expansion. Other houses specialise in so-called 'buy-and-build' investments; here, markets ripe for consolidation are targeted, with the investors backing a management team to acquire multiple Targets over time to produce a leading market player as that consolidation takes place.

By their nature, growth and development capital deals often result in the investors holding minority stakes, which can have particular implications when drafting the equity documentation. The deal may be structured by way of a direct investment into the company itself, or by the setting up of a new company which then acquires the existing Target in exchange for cash and shares (which is usually necessary for tax reasons where any or all of the existing shareholders are extracting value as part of the transaction).

(f) Secondary buyouts

A 'secondary buyout' describes a transaction where an existing company created as a consequence of a buyout backed by original private equity investors is sold to a new buyer vehicle backed by new private equity investors. The management team may remain the same across the two transactions, or there may be individual changes.

Secondary buyouts were particularly common in the UK during the period from 2003 to 2007. They may arise in a range of circumstances, and give rise to particular issues for the legal adviser – chapter 12 explores these issues in more detail.

2.2 The emergence of private equity

Private equity as it is currently known can be traced back to the end of the Second World War in both the UK and the US, by the establishment of venture capital firms on both sides of the Atlantic (notably the American Research and Development Company and J. H. Whitney and Company in America, and the

Industrial and Commercial Finance Corporation (now 3i) in the UK). Prior to that time, such investment was primarily sourced from wealthy individuals. The success of such institutions was supported by the respective governments at that time to encourage enterprise to help with the post-war rebuilding effort.

Until the 1980s, most investments by these firms, and other investors established in their wake, would largely fall under the modern categories of venture or development capital. Whilst more modern, and leveraged, buyouts did occur between the 1950s and the 1970s, the asset class really came to prominence during the boom years of the 1980s, particularly in America where a number of significant deals were completed. One of the last major buyouts of that decade was also, and probably remains, the most celebrated or controversial (depending on your point of view), being the US$25 billion takeover of RJR Nabisco by KKR. It was at the time the largest buyout in history, and retained that title for nearly twenty years, the events surrounding the buyout being famously documented in the book *Barbarians at the Gate*.[3]

Whilst the recession experienced at the start of the 1990s had the effect of derailing for a time the growing trend towards bigger and bigger buyouts, a number of key private equity players nevertheless emerged or were created during that decade as the market recovered from around 1992. Many still referred to themselves as venture capitalists, and deals in the UK often did have a venture, development or growth element in this period. Many players had a strong focus on venture and start-up capital, with a particular emphasis on technology and dot com businesses towards the end of the twentieth century (with the result that many suffered significant losses with the burst of the dot com bubble in 2000).

The three-to-four-year period leading up to the summer of 2007 saw an unprecedented boom in buyout activity in many developed economies, including the UK. A number of new players continued to emerge – at the time of writing, the latest edition of the BVCA handbook lists over 200 investors in the UK market – but, most notably, the size and scale of leveraged buyouts increased to unprecedented levels. Whilst in America the RJR Nabisco record was finally toppled, in the UK deals, or attempted takeovers, emerged with similar ambition and involving household names such as Alliance Boots, EMI and (unsuccessfully) Sainsbury's. This brought private equity very much into the public eye; the relatively light-touch disclosure requirements of a private-equity-owned business when compared with a listed company, the attractive tax treatment attached to the returns achieved by individuals working in the industry,[4] and inevitable questions around the short-term motives of investors led to considerable political pressure, culminating in a high-profile review by a Treasury Select Committee in June 2007.

3 Bryan Burrough and John Helyar, *Barbarians at the Gate – The Fall of RJR Nabisco* (1990).
4 See also chapter 9, section 2.5.

Since these buoyant times, the fallout from the credit crunch which began in Autumn 2007 has been well documented in the business press and the wider media. The structuring of LBOs has left private equity investors exposed to a significant, or possibly full, write-off of their investments in the event of business failure, whilst the increased leverage of existing businesses to facilitate deals made such failure more likely. At the time of writing it is unlikely that debt funding is going to be readily available to facilitate higher value LBOs in the foreseeable future,[5] and the political pressures on both sides of the Atlantic and in particular at EU level for increased regulation of alternative assets, and the wider financial services industry, is likely to have a significant impact on the private equity landscape.

The Walker Report[6] is a case in point. Commissioned during the boom period in February 2007, and published in November that year, Sir David Walker's guidelines for disclosure and transparency in private equity require additional disclosure and communication by private equity firms and their portfolio companies where particular thresholds apply, namely, where such portfolio companies:

(a) have more than 1,000 UK employees; and
(b) generate more than 50 per cent of their revenues in the UK; and
(c) either had an enterprise value of more than £500 million when acquired by one or more private equity firms or, in the case of a public-to-private transaction, had a market capitalisation together with a premium for acquisition of control of more than £300 million.

Given the substantial nature of these thresholds, the application of these guidelines is limited to a relatively small number of investments held by the larger players. However, private equity firms whose investments fall below the radar may do well to become familiar with the requirements; given the continued political scrutiny (particularly in the European Parliament), and public and media interest, it seems inevitable that similar transparency requirements will emerge in a form that will have implications for a larger proportion of private-equity-backed companies.[7]

That said, there is also little doubt that private equity will continue to play an important role in the UK economy. Whilst critics may highlight excessive leverage, cost-cutting measures or so-called asset-stripping, supporters of the industry will point out that an effective incentive for management to grow,

5 For more detail concerning the impact of the credit crunch on the availability of debt for leveraged deals, see chapter 6, section 2.
6 Sir David Walker, *Guidelines for Disclosure and Transparency in Private Equity* (20 November 2007). The independent review was carried out at the request of the BVCA and a group of private equity firms.
7 A practical checklist of the requirements for a company's accounts incorporating the Walker Guidelines can be found on the BVCA website.

or otherwise improve the performance or competitiveness of, the underlying business is inherent in the buyout model. This in turn can lead to increased employment, and the distribution of a substantial part of the profits to wider society as a result of the considerable participation in private equity funds by many pension schemes.

2.3 Types of private equity investor

In the UK, private equity firms come in a variety of shapes and sizes. It is important at the outset to distinguish between a private equity firm and a private equity fund. A private equity firm is an investment manager which raises pools of capital, typically in the form of private equity funds, to invest. These firms receive a periodic management fee for doing so, as well as a share in the profits known as a 'carried interest' from each of the private equity funds that it manages. As is outlined in chapter 3,[8] the typical arrangement in the UK is for the private equity funds to take the form of limited partnerships, with the private equity firm being the general partner of such limited partnership. A transaction usually involves the private equity firm arranging an investment by two or more limited partnership funds under its management in parallel. As a result of this structure, the investors in private equity funds are often referred to as 'LPs', and the private equity firms themselves as 'GPs', in the business and financial press.

Private equity firms are often ranked based on the value of the funds under management, or typical deal sizes for that investor. Common terminology is to divide the UK buyout market into upper-market, mid-market and lower-market – although the deal sizes falling within each category are not always consistent, and the mid-market is itself sometimes then divided into lower and higher sub-divisions. As a general rule of thumb, as at January 2009 most would describe deals with a transaction size of less than £50 million as lower-market, those with a size of £50 million to £500 million as mid-market, and those exceeding £500 million as upper-market.

The upper-market is dominated by the larger American and UK firms. Firms operating in the UK in the mid-market are often distinguished based on whether they are 'captive', 'semi-captive' or 'independent'. A captive investor obtains their funds exclusively from a parent company – usually a financial institution. These include those firms investing on behalf of the well-known UK banks. An independent firm will source all of its capital from external investors. A semi-captive combines the two approaches – investing the parent company's money alongside externally raised funds. Many of the independent firms operating in the mid-market in the UK were established by individuals who had previously worked in the larger buyout houses or within a captive or semi-captive environment, and similarly a number of such independents

8 See chapter 3, section 3.3.

were created as a result of the buyout of a captive or semi-captive firm by its managers.

Another way to categorise the UK market is by the sectors in which the various firms invest. Some firms will state that they do not focus on specific sectors, preferring a general approach, whilst others limit their investments to a particular sector or small number of sectors. In reality, the generalists will still have certain sectors in which they prefer to invest, or would like to invest, influenced by their existing funds, the sector experience of their key managers, and their view of where the best returns may be made.

Venture capital investment is typically the focus of distinct venture capital houses. Some investors in the upper-market and mid-market buyouts sector will also provide a separate venture capital offering too (especially where the firm is captive or semi-captive), although this may be presented using a similarly named but separate venture capital brand. Many venture capital investments are made by venture capital trusts (VCTs), a quoted entity which offers individuals the opportunity to participate in venture capital with particular tax advantages. The requirements for such investors are not detailed in this book, which focuses on the buyout market rather than the venture capital market, but it should be noted that there are strict requirements for the structuring of VCT investments which must be adhered to if the favourable tax treatment is to be obtained. These requirements can result in a VCT being less flexible than an LP structure.

Unsurprisingly in the economic climate subsisting at the time of writing, an increasing number of distressed and special situation funds have emerged, although this is by no means a new concept; successful specialist investors have existed for many years. In a private equity context, the expression is generally used to describe those investors who look to acquire distressed businesses (often at a significantly discounted, or even negligible, price arising from an insolvency process), and then implement strategic and operational improvements with a view to a successful *turnaround* of the fortunes of the business. Whilst many investors may claim interest in this particular area, quite different skills and expertise are required when compared with more conventional buyouts. It should also be noted that a range of alternative asset classes exist in the distressed and special situation arena outside these types of transaction – for example, hedge funds and other investors often employ strategies for dealings in debt in distressed companies.

Other sources of funding are also available to businesses which, in the broader sense, constitute private equity. For example, ‘business angels’ (high net worth individuals, often investing via an informal syndicate led by a recognised intermediary) often fund investments in the so-called ‘equity gap’ – a phrase typically used to describe transactions requiring equity investment of less than £1 million which most mainstream private equity investors have moved away from. At the other end of the scale, ‘sovereign wealth funds’ have emerged as key players in the upper market, often competing with the more traditional large private equity firms in the higher profile deals during the 2003–7 buyout boom. This book focuses on the typical requirements, and issues faced, in a more traditional buyout – although a number of these points will still be relevant to these alternative investors. The legal practitioner should, however, always be mindful of the need to fit the legal documentation to the deal, rather than the other way around; the principals will become frustrated if excessive cost is incurred negotiating comprehensive content on a smaller deal, particularly if the issues are not of concern to the investor, or worse still simply not relevant.

2.4 Sourcing the deal

One of the most important aspects of any management buyout process from the private equity funder's perspective is the identification of a suitable opportunity. This will vary according to the circumstances in which each particular deal arises – although general trends also emerge based on the prevailing market conditions.

For example, in the bullish market in the UK leading up to the summer of 2007, the opportunities often presented themselves – that is to say, the sellers (whether corporate or private individuals) instructed corporate finance advisers to undertake a formal marketing process, typically involving an extensive auction. An information memorandum relating to the Target, its business affairs and prospects would be prepared by the sellers' corporate finance advisers and made available to potential bidders. The bidders approached would often include both trade buyers and private equity or other financial buyers (in the latter case, these would usually be selected having regard to their interest and credentials in relation to that particular sector, and at the relevant deal size). Assuming there was significant interest, an aggressive deal process ensued, with tight timescales for completion of the transaction.

Although this formal marketing process, and resulting wider auction, has its attractions to any seller seeking to maximise value from disposal, it can be unattractive to private equity buyers and trade buyers alike (with the result that, during that bullish market, many credible buyers were reluctant to participate in such auctions). Some private equity funds have been set up, formally or informally, on the basis that they will not take part in auction processes. The strength of bargaining power of the seller demonstrated by a strict process, designed both to maximise value and to achieve a high level of execution certainty before agreeing to proceed exclusively with a particular bidder (or even without granting such exclusivity at all) meant that each potential bidder had to undertake ever increasing amounts of preparatory work including, in many cases, the incurring of legal, accounting and other professional costs. The fact that each potential bidder was exposed to these considerable costs and expenses, and also seeking to maximise its offer in such a way as to exclude other bidders, meant that many interested parties