A Practical Guide to Private Equity Transactions

This overview of a complex and often misunderstood subject takes the reader through the issues that are faced throughout the life cycle of a private equity investment, from the identification of an opportunity, through the various stages of the transaction and the lifetime of the investment, to the eventual exit by the investor. The analysis of key documentation and legal issues covers company law, employment law, pensions, taxation, debt funding and competition law, taking into account recent legal developments such as the Companies Act 2006, the recent emergence of private equity in the UK and the challenges faced by the industry as a result of the financial crisis.

GEOFF YATES is a corporate partner with Addleshaw Goddard LLP, where he specialises in private equity. He has acted for many years for both private equity houses and management teams on a range of transactions including MBOs, MBIs and 'take private' transactions. A member of the CBI Companies Committee, he is a regular public speaker on private equity and company law matters.

MIKE HINCHLIFFE is a partner at Addleshaw Goddard LLP, with over ten years' experience advising private equity firms, banks and investee companies in the UK on MBOs, MBIs, development capital and venture capital transactions. He also advises a number of private equity investors in relation to the ongoing management of their portfolio companies and exits.

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GEOFF YATES

and

MIKE HINCHLIFFE

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Foreword

This book runs to some 400 pages and delves into the very heart of how private equity deals work, yet the concepts that it describes and the methods that it unpicks are simple ones. Private equity is not reliant on complex algorithms or other financial wizardry for its successes, but on the expertise of its managers, who know their business sectors intimately and understand what decisions to take and when to take them.

The operating model of private equity is very straightforward and this model can be applied to businesses which possess wildly differing characteristics. This is one of the fascinating aspects of the private equity industry; from a high street clothes shop to a waste treatment plant, a cereal maker to an aerospace parts manufacturer, the fundamentals which govern everything that a private equity firm does remains more or less the same regardless of the industry in which the target company operates. Private equity invests in businesses which have reached a plateau and need private equity expertise and resources to grow, or those which have suffered from underperformance or stagnation due to imperfect management and need to undergo significant change in order to be revived.

In all of these cases, the model works because it aligns the interests of the people running the business with the private equity investor, providing those people with the monetary and operational support they need. The overriding goal is for the private equity firm and the management team it supports to sell the business for a greater sum than that for which it was bought, and the only way to do that is to ensure that what you are trying to sell is an improvement on the entity you originally acquired (a strikingly simple philosophy which debunks the notion that private equity success is down to 'asset stripping'). Management of the company and the private equity firm are both working towards this same goal, and the structure of the fund is such that rewards are always tied to long-term success. This model does not eradicate failure but does focus minds by ensuring that, in the event of failure, no one is rewarded.

Many private equity funds are organised as a fund which has a life of a minimum of ten years, during which the limited partners are locked in. The virtue of this is that it affords a private equity firm the time to take a long-term

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investment approach. Jittery investors cannot redeem their money and the fund is under no pressure to sell assets for a knockdown price. As tough as this recession has been for some portfolio companies, private equity firms are putting this long-term view into practice by supporting viable companies with injections of new money and hands-on help. For many, this support will ensure they are as prepared as they can be to survive the downturn by saving jobs, preserving value and putting the company in the best position possible to thrive once the upturn begins.

The bottom line, ultimately, is that, for private equity to be able to raise the funds from institutions such as pension funds to buy companies and to improve and sell them, they need to demonstrate that investing in a private equity fund for ten years or more will be more profitable than other routes. This is what private equity has been able to do and, even during this downturn, continues to do.

According to research undertaken by Capital Dynamics and PricewaterhouseCoopers for the BVCA's annual Performance Measurement Survey, private equity funds recorded an IRR of 15.4 per cent over the ten years up to 2008, compared to 3.7 per cent for total pension funds assets and 1.2 per cent for the FTSE All-Share. This level of performance is one that private equity has delivered consistently, according to the same data. From December 2000 to December 2008, IRRs have ranged from a low of 13 per cent to a high of 17.3 per cent, a period which has encompassed the dot com crash and the current recession. This stability is made possible because of private equity's long-term outlook and ability to adapt to changing market conditions.

The adaptability of private equity will ensure continued returns at these levels. The industry is playing a role in helping the economy through the recession by rescuing companies from administration and, as any experienced practitioner will tell you, previous funds raised during downturns have gone on to record outstanding returns to investors. So, those of you reading this book considering a career in private equity, or who have recently begun work in the industry, take heart: this industry is a resilient one, predicated on a simple, yet flexible, model and a downturn is an opportune moment to demonstrate the strengths of this model.

Simon Walker
Chief Executive, British Private Equity and
Venture Capital Association

Preface and acknowledgments

In recent years, the private equity market has experienced dynamic growth in the UK. However, the credit crunch that began in the summer of 2007, and the resulting recession being experienced at the time of writing this book, have created far more challenging market conditions for the industry. The purpose of this book, therefore, is to capture the practice prevailing in the market not only before the market turned, but also in the more challenging environment that has emerged since. To a degree, that latter practice is still developing of course – but, as this book highlights throughout, an understanding of how private equity deals were structured and transacted during the recent boom period will help the reader appreciate how such market practice is adapting, and will continue to adapt, to the more uncertain conditions currently being experienced. It is also our view that private equity will continue to make a significant contribution to UK industry notwithstanding these uncertain market conditions; in all uncertainty lies opportunity.

We have designed this book to guide the reader through the principal issues likely to be faced in transactions in the UK private equity market – from the initial business planning, due diligence and negotiation of the investment, through the life of that investment for the management team and the investors, concluding with a successful (or perhaps less successful) exit. The book also considers in some detail the practical issues that can arise in specialist areas – particularly banking, tax, pensions, competition law and employment law – all of which combine to define the structuring and terms of any transaction. This approach is intended to help the practitioner understand how the pieces of the private equity jigsaw fit together – for example, how decisions made at the time of the original deal can impact on the ability of the private equity investors and the managers to operate the business during the life of the investment, and how the need for a successful exit drives the original deal and informs the attitude of private equity owners when making investment decisions.

This book is not intended to inform the reader of everything that he or she needs to know about buying or selling businesses in the UK, nor does it provide any detailed analysis on the structuring of private equity funds. There are other titles specialising in those fields. Its aim is to give the reader an understanding of how private equity works in practice in the UK, and the practical differences that the nature, structure, motivation and objectives of private equity investors bring to UK deals.

We should like to take this opportunity to thank Michael Carter (share schemes), Matthew Doughty ('take privates' and IPOs), Ed Jenkins (tax), Catherine McAllister (pensions), Phil McDonnell (competition), Phil Slater (banking) and Richard Yeomans (employment) for their invaluable contributions to the relevant sections in this book. We should also like to thank David Ascott, Chris Leonard and Mo Merali of Grant Thornton for their contributions to the sections dealing with the Business Plan and financial due diligence. Last, but by no means least, our sincerest thanks to Carmel Craddock who was not only responsible for typing the vast majority of this book, but has also provided invaluable word processing support on many of the transactions that have contributed towards its content.

Much of this book is informed by market practice in the UK as experienced by the authors. It is hoped that future editions can benefit from the experiences of readers of the book as market practice continues to develop, and therefore any comments, queries or suggestions on the text are both encouraged and welcome.

We have, where relevant, used the section numbers from the Companies Act 2006 which will be fully in force by 1 October 2009. Save for that fact, and unless otherwise stated, this book reflects the law and practice as at 1 July 2009.

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