Private Equity Demystified

The fundamentals of private equity deal structuring

Private equity in many scenarios can be a win-win for both the founder and the management team, enabling the business to grow with the support of experienced investors and generating significant financial uplift for all shareholders on the ultimate exit.

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The fundamentals

Private equity ("PE") funds are institutional funds targeting investment in privately owned businesses. The nature, size and structure of the investment can vary significantly but generally PE funds are seeking to provide growth capital or support buyouts unlisted entities with a view to securing strong returns on behalf of their investors over a pre-determined lifetime.

Growth in the target businesses is delivered by working with the management team to improve performance, deliver on a business plan that is mutually agreed between the parties, drive operational performance and make strategic investments.

While venture capital is focused on start-up enterprise, private equity supports established businesses through growth and expansion – as well as backing management teams (either existing or assembled) to buy out founders either in whole or in part. Where these buyouts are partially funded through debt, they are referred to as leveraged buyouts ("LBOs").

The operating model of private equity varies between funds. While some funds target underperforming businesses and turnaround opportunities for example, others are focused on backing best in class management teams delivering exceptional growth. The level of operational involvement also varies significantly between private equity funds, and finding the right partner to fit the objectives of any particular business and management team is key.

A happy outcome for both management and founders?

Private equity deals can be pure growth capital (ie. all cash in) or can support a complete or partial buyout by the management team. By retaining some equity, and ideally investing pari passu alongside the PE fund, the founder can benefit from significant upside on the ultimate exit by the PE fund. This effectively enables founders to invest commercially in a business they know exceptionally well, while operationally reducing their involvement in the business and significantly de-risking their investment.

Private equity funds are very active in the Irish and UK markets and in many cases can pay a higher price than trade buyers, particularly where they believe in the strength of the management team and the business plan for the business. PE deals in the Irish market have continued to grow in H12016, with 13 PE deals completed in the first half of this year, up from 10 in H12015. Growth capital (i.e. all cash in) deals can be an attractive structure for owner managers to raise growth capital from highly experienced investors, usually to support buy-and-build acquisition strategies, with less reliance on leverage. There can be a reluctance by owners to sell equity to support growth strategies, but with the right structure and partner, the returns for both the founder and the investor can be very attractive.

For management teams, private equity is a source of not just capital but also professional investors who are highly experienced in working with high performing teams delivering on ambitious business plans. The PE funds will usually help supplement the Board of the business and provide strong input in advising the team on the delivery of their plan. This will often include particular sector expertise, experience in internationalisation, expertise in executing on acquisition strategies and access to particular skills (e.g. digital or sourcing experts).

How are PE deals funded?

The private equity funds themselves are backed by a range of sources (Limited Partners or LPs) including institutions such as pension funds, insurance companies, high net worth individuals, government bodies (including ISIF in an Irish context) and banks. The stage of a fund cycle of any particular fund considering a deal is a very relevant indicator of appetite and capacity to transact. PE funds with recently raised funds will typically be aggressively pursuing new deal opportunities. This can be more challenging pre or mid fundraising.

In conjunction with the equity funding from the PE fund, debt will usually represent a significant portion of the funding to support a transaction. This is typically senior debt and may also include working capital facilities, and there is often secondary debt sitting alongside senior debt. Evaluating the overall funding structure and associated cost in the financial model of the target business to understand future cash flow impacts for the business, in line with the overall plan for growth, is a key element of the Vendor advisor's role; working closely with the finance team to ensure that the business is appropriately structured to deliver on its business plan. Debt can be stapled or soft stapled (where in effect the terms of the debt are secured/agreed by the Vendor's advisors such that the Bidders are all assuming similar minimum debt terms); which impacts directly on the size of the equity cheque and the overall price. For the business going forward, ensuring that the level of debt in the business post transaction, the caveats, repayment terms and structure of the debt package is appropriate and not restrictive is key, particularly if an ambitious growth plan is being pursued. This is also somewhat linked to the level of surplus cash being extracted by the founder at completion, and the overall capital structure of the entity post transaction.

PE Deal structuring

Typically, PE funds will incorporate a chain of holding companies for each acquisition that a particular fund makes. The jurisdiction of incorporation of these holding companies may vary, depending on tax considerations, investment structure and the location of the target company. For Irish investments, typically the buyer entity and any intermediate holding companies will be made up of Irish incorporated special purpose vehicles. Intermediate holding companies are often used to issue high yield bonds or to enter into debt facilities for the purposes of acquisition financing.

The entity in which the PE fund and management will hold their equity ("TopCo") will usually sit on top of the chain of the local holding companies.

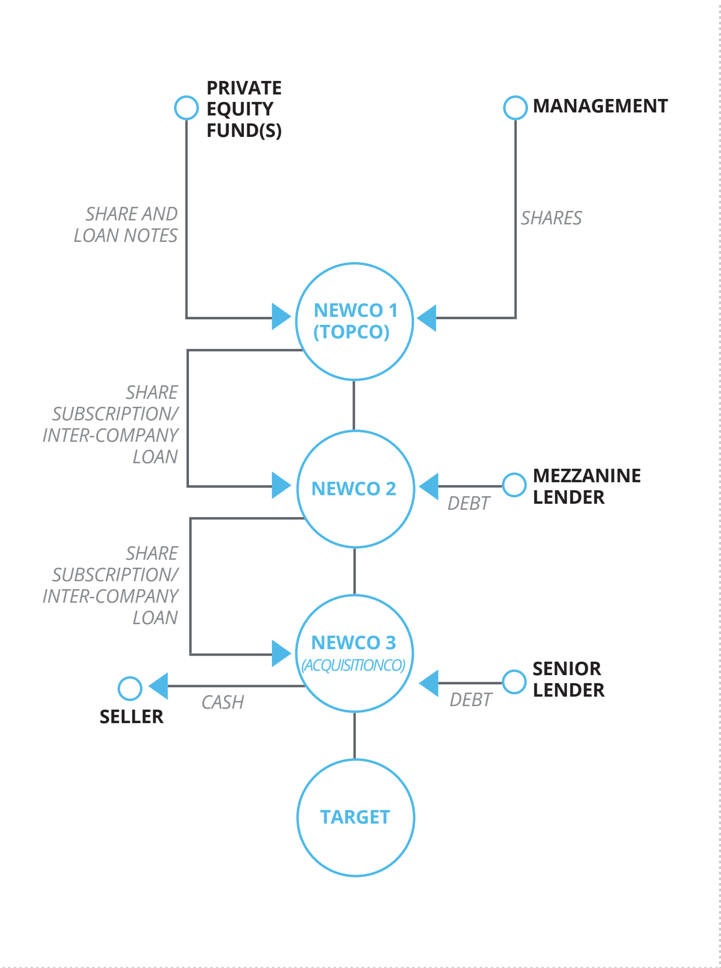
Further up the chain of holding companies, the companies may be incorporated in other jurisdictions such as Luxembourg or the Netherlands, depending on particular capital structuring and tax considerations. One of the key considerations for the PE fund will be to ensure that, on exit, the proceeds of sale of the target company can be returned to the PE fund (and its investors) with minimal delay, tax liabilities and other friction costs.

In most cases, on completion of the acquisition of the target company, the buyer entity will acquire the shares in the target company from exiting founders and other shareholders in exchange for cash consideration, with any management who held equity in the company or shareholders who are remaining post-acquisition receiving shares in the buyer. These buyer shares will then be "rolled up" the chain of holding companies to the TopCo, to ensure that the remaining non-PE shareholders hold their shares at the appropriate level in the holding structure.

Normally, the amount subscribed by the PE fund for ordinary shares in TopCo, alongside management, is only a very small proportion of the money that it invests. The rest of the investment is made as shareholder debt, usually in the form of loan notes or preferred shares.

There are two main reasons for this approach. As loan notes or preference shares rank ahead of the ordinary shares on exit, the interest payable on these securities provides a hurdle that must be cleared before any value accrues to management's ordinary shares. Also, if the transaction is structured correctly, loan notes may enable the group to obtain a tax deduction against profits for any interest payable on the loan notes (on an accruals basis) across the term of the loan notes.

A typical deal structure may look something like this:



Private Equity Deals – The Documents

The principal transaction documents for a PE deal usually include:

- Share Purchase Agreement - whereby the buyer acquires the target company and pays the cash/ share consideration;
- Investment/Shareholders' Agreement - whereby shares in the buyer are "rolled up" the holding company structure immediately post-completion and which governs the management of the group and the relationship between the shareholders until an exit;
- Articles of Association – which sets out the rights attaching to the TopCo shares and other shareholder rights and obligations;
- Service contracts – between management and the group setting out the terms of their employment post-completion and any restrictive covenants;
- Debt documents – facility agreement, security documents and any intercreditor agreements; and
- Warranty and indemnity insurance policies – insurance cover for liability arising from warranty and indemnity claims is widely available and commonly utilised in UK deals, and is becoming increasingly common in Irish transactions.

PE Structures – the hotly contested areas *(other than the price!)*

- Warranties and indemnities (from seller in the SPA, and from management in the investment agreement or a separate management warranty deed)
- Limitations on liability
- Restrictive covenants
- Sweet equity
- Tax requirements (PE fund vs. management)
- Leaver provisions
- Drag and tag options
- Restrictions on transfer
- Ability to syndicate/bring in co-investors at the time of, or after, the acquisition
- Loan note/preference share coupons
- Rollover rights versus PE rights, and preferential returns
- Level of leverage
- Structural subordination of junior lenders vs. senior lenders
- Minority protections and swamping rights
- Follow on funding provisions and dilution rights
- Completion mechanisms / Locked box structures – surplus cash and net debt

The Ultimate Exit

For the PE provider, their returns are driven by a combination of yields over the life of their hold (typically via a coupon on loan notes invested and debt refinancing) and capital gain on the ultimate exit. Investment hold periods vary, but c.5 years is a good approximation. For a founder and the management team, the ability to articulate well considered exit options at the point of entering discussions with a PE fund is a key positive. This gives the PE investor comfort in ultimate exit options and certainty of generating capital returns; with a potential positive impact on price, particularly where the process is competitive. For this reason, founders often run dual processes with trade and private equity, with trade considerations during the unified process giving PE providers comfort on likely trade Buyers on the ultimate exit by the PE investor.

Executing on a private equity transaction –

Top tips for a successful transaction

- **Be well prepared** – if considering a PE transaction vendor due diligence is highly recommended. The level of DD undertaken by a PE fund, in particular on the business plan, the forecasts and quality of earnings is significant and the business needs to be prepared
- **Understand potential red flags** and address them in advance of a deal - it's much better to be aware of and address where possible potential deal issues in advance of a transaction rather than an investor identifying major deal issues during due diligence
- **A comprehensive business plan** – a private equity backer is investing in the future growth of a business. Prepare a business plan backed up by a financial model with growth rates that support private equity target returns and leverage structures. The management team must believe the plan and assumptions need to be reasonable
- **Align the objectives of the management team and the shareholders** – there are natural conflicts in any transaction, and in particular in PE deal structures with buying and selling shareholders. Understand the objectives of all of the key stakeholders and agree the level of rollover and involvement in the business post transaction upfront (i.e. who is exiting, what stake is everyone selling, who is reinvesting and to what level? Etc.) This makes the level of the equity available for sale to the PE investor clear from the outset which may be a combination of growth capital in and cash extraction
- What are you looking for in an investor? – **Agree your objectives** and what you are looking for in a private equity investor e.g. access to new markets, expertise in supporting buy-and-build strategies, an ability to provide follow on funding, strength of Board appointments, etc. The approach, strengths and focus areas vary from fund to fund. Considering what you are looking for in your investment partner and identifying the right funds for you will help make sure you find a fit that's right for your business
- **Capacity of the management team** – one of the main reasons deals fail is the management team becomes distracted with the deal process and all it entails, and the underlying trading performance of the business suffers. Ensure the finance function has the capacity for a transaction; and prepare in advance. Structure the deal team such that management have the bandwidth to also run the business. Consider the sale process timetable in light of peaks and troughs in trading in the business
- **Debt funding** – there are a number of ways in which the Vendor can take control of the debt process, including soft stapling or stapling of the debt. This helps ensure that the private equity bidders are basing their valuation on comparable assumptions that work for the business; and that the debt process (to the extent applicable) does not become a barrier to the completion of the transaction
- **Knowing the market** – often the terms of PE deals will be dictated to a large extent by what is seen as standard market practice for these types of transactions. Any attempt to deviate from perceived market practice will require a strong objective justification before it will be accepted by a PE fund (if at all)

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