PRIVATE EQUITY

KNOWING THE NEXT MOVE

DEMYSTIFY | NAVIGATE | ACCELERATE | REALISE

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IDEAS | PEOPLE | TRUST

BDO

BDO – DEMYSTIFY

Private Equity investment enables entrepreneurial businesses to expand at speed, and clears the way for skilled and ambitious people to step up a gear. If managed in the right way, Private Equity can be an exceptionally positive route to growth.

HEAR FROM OTHER ENTREPRENEURS WHO HAVE BEEN THROUGH THE PRIVATE EQUITY JOURNEY.

Using Private Equity should be a positive and exhilarating experience especially for those doing it for the first time. It can help entrepreneurial businesses and their leaders professionalise, grow and achieve transformation in their business. In fact, taking on Private Equity can help an entrepreneur become more entrepreneurial.

Private Equity houses are often tarnished by the headlines of a rogue few, making it difficult for some entrepreneurs to distinguish fact from fiction. However, there are very few real predators out there looking for an opportunity to take advantage.

We believe there is a more balanced truth for those with a clear purpose, an ambition to embark on the next phase of growth and the stamina for this transformational change over a relatively short period of time.

Deciding that Private Equity is the right choice and finding the right partner for our clients is very important to BDO. Our knowledge and understanding of this market is deep-rooted in the heritage of our business.

Through our relationships with, and understanding of Private Equity, we help businesses assess the opportunity, avoid conflict and find the right solution for maximum effect.

As the home of the entrepreneur, we are founded on helping entrepreneurially-spirited clients along the whole life journey of their businesses and often, a part of that is spent in the Private Equity world. We have years of relevant experience.

Starting with the demystify phase, we help to dispel the big misconceptions and broaden knowledge of how Private Equity works so that decisions can be taken on an informed basis. We bring people together from across our business and our network to help our clients achieve their long term goals, that may go beyond their immediate Private Equity ambitions.

A BASIC VALUATION MODEL

Private Equity houses look to drive growth in value, therefore, it is useful to have a basic valuation model in mind.

The one that we use looks at value through four lenses:

- **Revenue Growth**;
- **Margin**;
- **Cash Conversion**; and
- **Risk Quotient**

Rationalising this, businesses that grow the fastest, that turn their efforts into profits the most readily, where the quality of those profits are the highest (ie profits readily turn into cash) and where the risks are the lowest, will be valued the most highly.

So, when thinking about taking on Private Equity, it is worthwhile looking at your business through these four lenses:

- How fast has your business grown and how fast could it grow in the future
- Empirically, companies with the highest growth, or with the expectation of the highest growth attract the highest valuations.

- How much effort (cost) do you need to make to turn your revenues into profit and what could be done to improve that
- Similarly, but not so visibly, companies with high margins are more highly valued by investors.

- How readily does your profit turn into cash and what could be done to enhance that
- Private Equity houses use debt to reduce the cost of capital and help drive equity value. Companies with high cash conversion can service more debt.

- How ‘risky’ is your business ie how resilient is it to bad things happening
- Companies that are seen as least risky are afforded high multiples. Often ‘scale’ is a proxy for safe, but visibility of earnings and good management reduces risk perception.

IF YOU COMBINE ALL THESE TOGETHER, YOU REACH THE HIGHEST VALUATIONS.

COMPANIES SUCH AS GOOGLE AND APPLE FOLLOW THE BASIC VALUATION MODEL AND AS A RESULT THEY'RE STILL FAST GROWING. WHEN CONTEMPLATING PRIVATE EQUITY, THINK ABOUT HOW YOU CAN DEMONSTRATE YOUR PROWESS IN THESE FOUR AREAS.

PRIVATE EQUITY

In our experience, there are four areas which should be focused on in order to drive value and maximise your value. Some considerations in each of these areas are set out as follows:

- QUALITY & VISIBILITY OF EARNINGS
- QUALITY OF MANAGEMENT INFO
- STRONG MANAGEMENT TEAM
- CORPORATE GOVERNANCE
- DIVERSE CUSTOMER BASE
- SYSTEMS & CONTROLS
- IT/ CYBERSECURITY
- LACK OF LIABILITY

- WORKING CAPITAL
- CAPEX
- TAX
- FINANCING

- VOLUME
- PRICING
- SALES MIX
- MAXIMISING BRAND AND IP
- BUSINESS DEVELOPMENT PRACTICES AND TEAM
- USE OF SOCIAL MEDIA AND ONLINE PRESENCE
- LEADERSHIP IN A GROWING MARKET

- EFFICIENCY / PRODUCTIVITY
- SCALE
- COST CONTROL

91%

OF PEOPLE WHO HAVE BEEN **PRIVATE EQUITY INVESTED** WOULD RECOMMEND IT

87%

SAW THEIR COMPANIES GROW UNDER **PRIVATE EQUITY OWNERSHIP**

OVER THE PAST 10 YEARS

PRIVATE EQUITY BACKED BUSINESSES HAVE RETURNED FOUR TIMES THE RETURN THE PUBLIC MARKETS WOULD HAVE RETURNED

HOW PRIVATE EQUITY WORKS

PRIVATE EQUITY:

Private Equity (PE) is a term given to investment monies that are most often aggregated into funds for investing predominantly into private companies. These investment monies are derived from pension funds, insurance companies, sovereign wealth funds, high net worth individuals and families and individual investors. Typically, the funds are closed end investment vehicles that have a 10 year life. This is an important factor as where a fund is in its life-cycle does influence investment behaviors. Often funds have extension provisions that can be invoked under certain circumstance so they can last longer than 10 years. A circumstance may be market driven (ie Global Financial Crisis) or particular to that fund (investments that are not right to be exited when the 10 years are up). Typically, funds look to be invested for 3-5 years and divested within 7-8 years if possible.

PRIVATE EQUITY HOUSES

A PE house is really a generic term applied to businesses that invest PE investment monies on behalf of the funders (pension funds, insurance companies etc.): they are advisers to the fund and are most normally a separate legal entity with a very different ownership group. The PE house could be referred to as the fund manager – in fact the PE house will have a contract with the fund to manage the investment monies. Often PE houses are also referred to as General Partners – known as 'GPs'. This is because of the partnership law under which many funds are structured where there is a general partner (the PE house/fund manager) and limited partners (the pension funds, insurance companies etc.) – known as 'LPs'.

The fund's terms will invariably require the PE house to invest its own money in the fund (they co-invest) and provide for fees and returns due from the fund to the PE house. Typically, the PE house will charge a fund management fee (a percentage of the funds under management) to cover the operational running costs of the PE house (employing people, rent, marketing costs etc.) and a carried interest, or 'carry'. The carry is often agreed as 20% of the returns of the fund over a threshold return. Historically, that threshold return has been 8% - the long term return on the equity capital markets.

The carry is split up amongst the, probably senior, team members of the PE house. In that way, the investment managers, executives and partners are all aligned with the success of each investment in the portfolio. Each team member will be asked to co-invest in the fund.

The term PE is used interchangeably for situations with different investment strategies from higher risk, often early stage investment, Venture Capital, through to multi-fund fund managers that might themselves be quoted, like Blackstone. Businesses like Blackstone manage many funds with different remits (large cap, real estate, special situations etc.) that you or I could invest in.

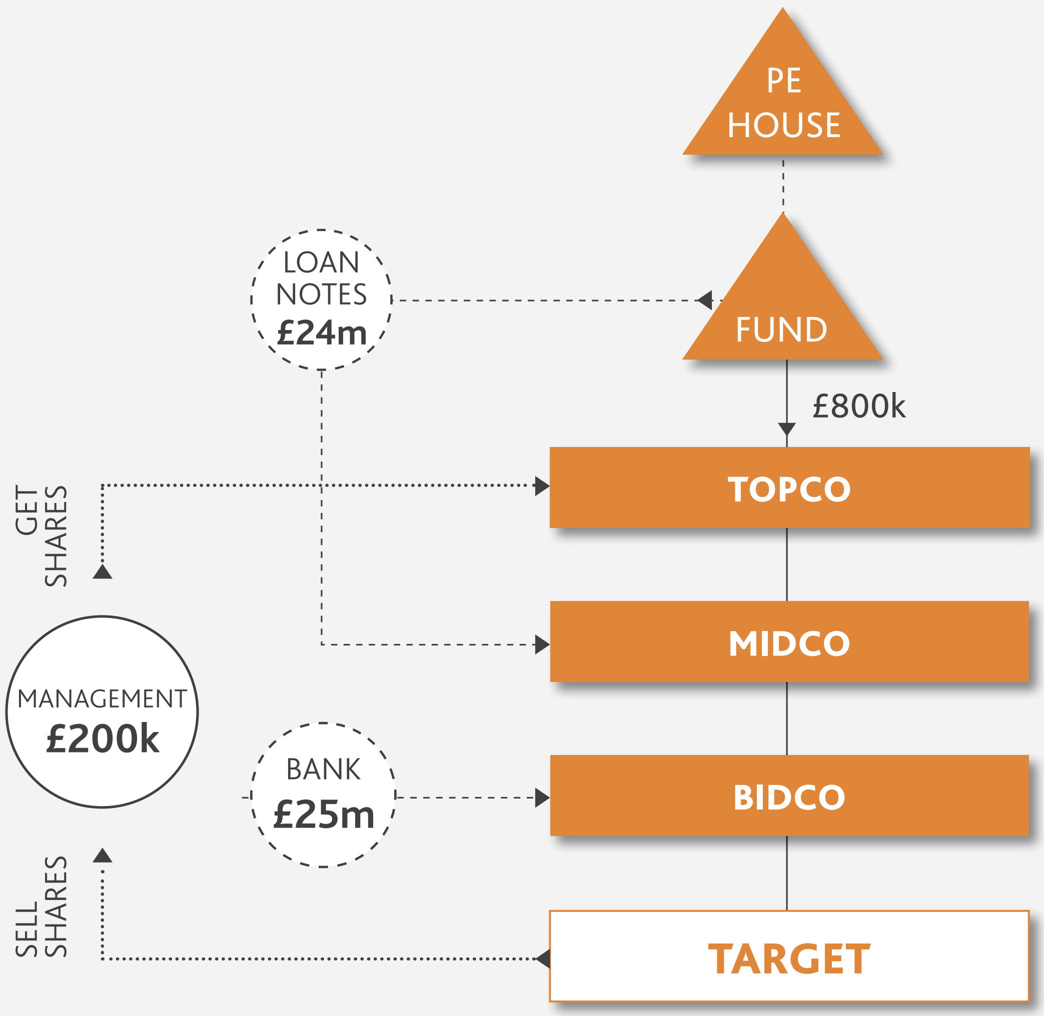
PE houses differentiate themselves by tackling different parts of the market. Typically:

- **Size/'cheque size'**: small cap (up to £50m); mid cap (between £50m-£350m); large cap, where cheque sizes are very large (£350m and over)
- **Geography**: some are restricted to invest in one geography, for example the UK (LDC); some are international, covering Western Europe for example (Equistone); and some are global (CVC, Blackstone etc)
- **Sector**: technology; healthcare life sciences; manufacturing etc.
- **Stage**: growth; stressed; distressed
- **Type**: majority or buy-out; minority or partnership capital; development capital; venture.

Some (mainly US based or large cap PE houses) use the terms leveraged buy-out or institutional buy-out. The first references the use of debt or leverage and the second references that the investment monies are largely from big institutions (pension funds and insurance companies). The terms are often used interchangeably, but they can convey subtle differences to the attitude of management.

In the UK there are approaching 1,000 PE funds and in the US there are a staggering 7,000.

TYPICAL STRUCTURE



HOW PRIVATE EQUITY WORKS
CONTINUED

HOW PRIVATE EQUITY INVESTS

The vast majority of buy-outs are largely funded through loan notes from PE houses and bank debt. Bank debt attracts an interest rate that is paid periodically, and loan notes attract a coupon (really an interest rate). Typically this is between 8% and 12%. The coupon can be paid but is most normally rolled up into the principal or paid by the issue of further notes, typically referred to as 'PIK' (Payment in Kind) notes. The balance is funded by a thin sliver of ordinary equity. All these funds are invested into a new company (often referred to as 'Newco') which is formed to make the acquisition of the target. The loan notes and ordinary equity are sourced from the PE house, often the vendors and invariably the management team. The element of ordinary equity and loan notes sourced from the PE house is referred to as the 'institutional strip'. The vendors and the management team often roll over a proportion of their value crystallised in the target because of the buy-out into loan notes and associated ordinary equity alongside the incoming PE house. If the proportions and the terms are broadly the same, they are said to have invested in the institutional strip. Management will invariably be asked to invest in the venture from their own resources, even if they have no value in the target. This is so all stakeholders have 'skin in the game'.

The ownership proportions of Newco are determined by the value of target, the relative amounts of funding being provided (bank debt, loan notes, vendor role and management investment) and negotiation. There are no hard and fast rules, but the more negotiating power the vendors and management have, the better their packages will be. The element of the ordinary shares owned by management that is not associated with loan notes is referred to as 'sweet equity'. It is called this when the plan is met or exceeded the percentage growth in value of this equity should far exceed the percentage growth in value of the institutional strip. For a sense of proportion, if the institutional strip is expected to double in value over the period of the investment, then the value of the sweet equity might be expected to grow to 10 times its initial value. Mathematically, as the sweet equity is not associated with loan notes, the ordinary equity that the PE house and anyone else invests in loan notes is diluted by the amount of the sweet equity.

Over the period of the investment, the cash generated by the target may be used to service and often pay down (or amortise) the bank debt, and sometimes the loan notes. However, most of the loan notes and the balance of the bank debt (often the majority of that) are repaid at exit (ie when the shareholders sell their stakes). As the returns on the bank debt and loan notes are restricted to the repayment of the principal plus any unpaid, but accrued, interest or coupon any excess growth in value accrues to the ordinary shares very much like how equity value accrues to house owners who use mortgages.

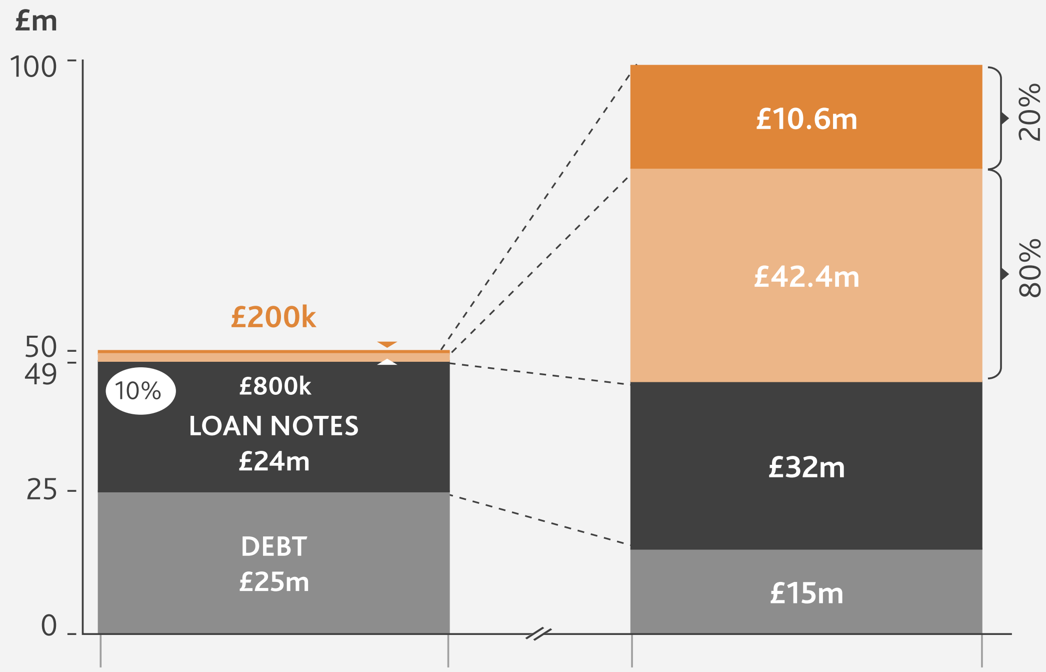
From the PE house perspective, it would like to invest in the highest returning lowest risk situations as they have the most chance of delivering the best returns. Good returns lead to good carry and good co-invest. Therefore, a PE house will do what it can to make sure that it really understands the risk that it is taking on, which it then tries to mitigate. Mitigation strategies include: paying less, carrying out extensive due diligence and structuring (earn-outs, preferences etc). Typically, PE loan notes have a liquidation preference to (ie gets paid out before) the ordinary equity. Sometimes, the PE house will look to negotiate that their loan notes are prior ranking to the vendor's and the management's loan notes.

HOW PRIVATE EQUITY MAKES MONEY

As time progresses, all being well, the business and its EBITDA grow, bank debt is paid off or amortised, the operations of the business are improved and the Enterprise Value (EV) will increase. This drives value into the ordinary shares (equity value), provided that the EV growth outstrips the total cost of debt and of the loan notes. There is further growth in equity value if there is 'multiple accretion', ie if the exit multiple exceeds the entry multiple. As you would imagine, executives in PE houses not only focus on growth of the EBITDA but also in all those things that might positively affect multiples. This will include keeping a weather eye on the market and the timing of any exit.

If everyone has done their job well and timing is picked well and the business has been prepared for the sale process well, the returns can be excellent for the fund, the PE house, its executives, the rolling vendors and the management team.

DRIVING VALUE INTO ORDINARY SHARES



	YEAR 0	YEAR 3
EBITDA	£5m	£10m
MULTIPLE	10x	10x
EV	£50m	£100m

AGENDA ALIGNMENT

Most entrepreneurial management teams are well aware of the importance of agenda alignment amongst the leaders of the business. This comes into sharp focus when a Private Equity investor joins the board. The investor agenda is likely to be simply to drive value. Altruistic objectives of management may not be shared by investors, although there is considerable growth in impact investing.

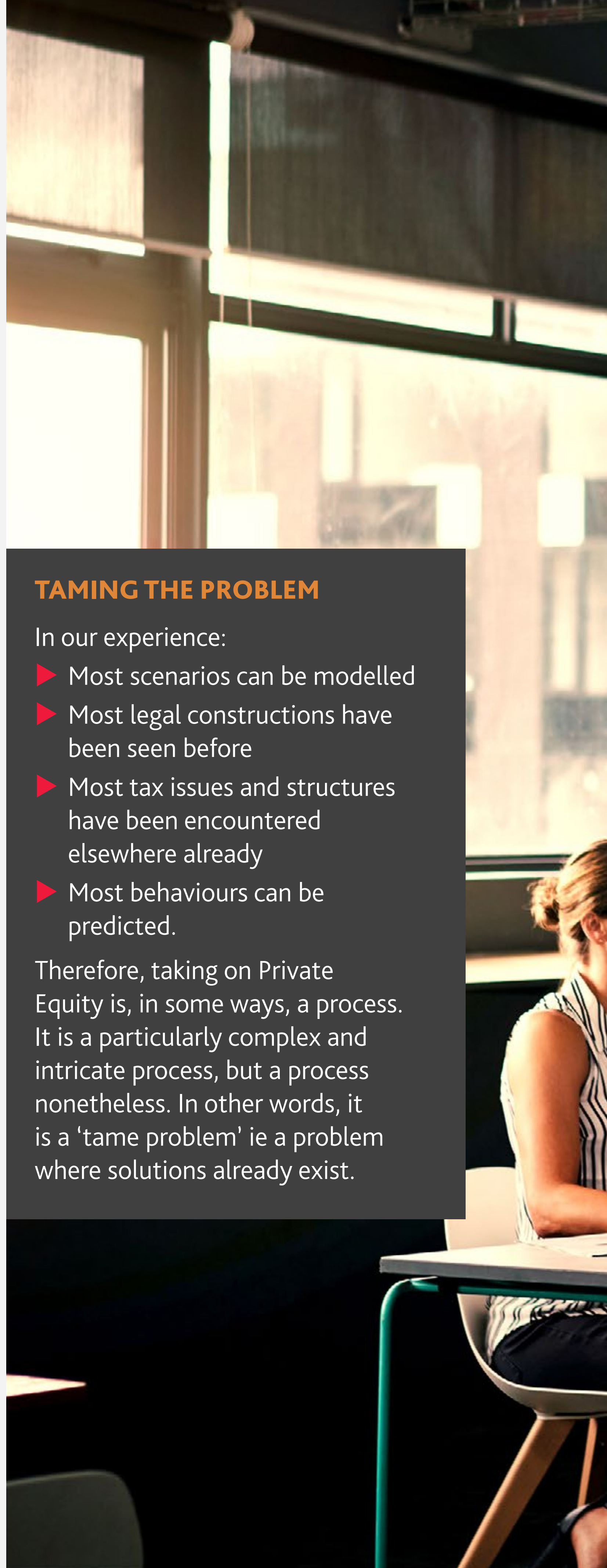
Real success in a relationship with Private Equity comes where there is significant alignment, and non-aligned factors can be clearly de-prioritised.

In our experience it is important to have absolute clarity about your own objectives and those of your team.

Questions you might find it useful to pose include:

- What is your definition of success for yourself and for your business over the medium & long term?
- What is your business plan to achieve this?
- How much investment do you require to fund your business plan?
- What alternatives are there?
- What are your 'non-negotiables'? ie the terms you would never sign up to
- How could you accelerate your plans and grow your business faster?

We typically help business owners to identify and prioritise their objectives and understand how they can be aligned with those of the Private Equity investor.



TAMING THE PROBLEM

In our experience:

- Most scenarios can be modelled
- Most legal constructions have been seen before
- Most tax issues and structures have been encountered elsewhere already
- Most behaviours can be predicted.

Therefore, taking on Private Equity is, in some ways, a process. It is a particularly complex and intricate process, but a process nonetheless. In other words, it is a 'tame problem' ie a problem where solutions already exist.

DEFINITIONS

Auction	A process in which an investment bank or other corporate finance adviser invites several Private Equity houses to look at a particular company that is for sale and to offer a bid to buy it.
BIMBO	Buy-in-management-buyout. A combination of a management buy-in (MBI) and a management buy-out (MBO).
Capital Markets	A marketplace in which long-term capital is raised by industry and commerce, the government and local authorities. Stock exchanges are part of capital markets.
Carried Interest	An entitlement accruing to an investment fund's management company or individual members of the fund management team. Carried interest becomes payable once the investors have achieved repayment of their original investment in the fund plus a defined hurdle rate.
Conditions precedent	Certain conditions that a Private Equity firm may insist are satisfied before a deal is complete.
Covenants	An agreement by a company that certain activities will or will not be carried out or that certain thresholds will be met.
Debt Fund	An investment pool, such as a mutual fund or exchange-traded fund (ETF), in which the core holdings comprise fixed income investments.
General Partner (GP)	An entity that raises capital from limited partners for a fund and determines which assets the fund should invest in.
Institutional Buy-out	A buy-out initiated by institutional investors, such as Private Equity houses, where they take a controlling interest in the business.
Leveraged buy-out (LBO)	A buy-out in which the Newco's capital structure incorporates a level of debt, much of which is normally secured against the company's assets.
Leverage	The use of debt in an investment, including acquisitions and capital expenditures.

Limited Partner (LP)	An entity that commits capital to a general partner's fund.
Management buy-in (MBI)	A buy-out in which external managers take over the company. Financing is provided to enable a manager or group of managers from outside the target company to buy into the company with the support of Private Equity investors.
Management buy-out	A buy-out in which the target's management team acquires an existing product line or business from the vendor with the support of Private Equity investors.
Payment in Kind (PIK)	An instrument that pays interest or dividends to investors of bonds, notes, or preferred stock with additional securities or equity instead of cash.
Sweet Equity	An instrument in the form of options, performance rights, or rights to further shares that increase the value of management equity relative to other shareholders. Often issued at a lower price to motivate management with the incentive of a higher upside when objectives are achieved.
Secondary Buy-out	A buy-out in which a Private Equity house sells control of a portfolio company to another Private Equity house.
Venture Capital	A type of Private Equity investing that focuses on startups and early-stage companies with long-term, high-growth potential.

PRIVATE EQUITY IN NUMBERS

PRIVATE EQUITY SPECIALISTS: THE BDO TEAM

BDO's Private Equity group is a highly collaborative network of more than 400 experienced advisers from all disciplines across the firm including audit, tax, M&A, transaction services and corporate advisory. This practical team has a profound understanding of the Private Equity industry, particularly in the mid market. Our people are part of the process at every level, interacting with funds, advising on deals, and working closely with portfolio companies to help them realise their goals.

>1,200 Private Equity backed companies work with us

We audit **>550** Private Equity backed companies

We work with **>250** Private Equity houses

In 2021 we completed **435** deals worth **£46bn**

68% of our deals involved Private Equity

Globally BDO's 2021 network revenues were **US$11.8bn** generated by **97,000** people across **167** countries

The investments we've made in infrastructure, resources and talent mean that we offer a powerful combination of service, scale and expertise; and through our deep working relationship with each client we can focus on their unique needs and deliver practical individual solutions.

We've never lost our agility and personal approach. We understand the intense pressure that comes with the challenge of entrepreneurial growth, and we work strategically alongside our clients. Private equity can offer huge rewards to businesses, but knowing how to manage it effectively makes all the difference. That's where our team comes to the fore.

CONTACT US

WE WANT TO HEAR **FROM YOU**

The reasons for embarking on Private Equity investment may be complex, but whatever your motivation, we are searching for ambitious businesses to champion through this chapter and enhance future growth.

Contact **JAMIE AUSTIN** on +44(0)77 7192 8208 for more information.
We look forward to meeting you and learning about your business.

READ THE NEXT IN OUR SERIES:

NAVIGATE

Appropriate if your business has reached a stage where speaking to Private Equity and preparing for potential investment is on your agenda. This will help you to navigate your way around Private Equity and investors.

Definitions in this document have been sourced from industry bodies BVCA and ICAEW ('A Guide to Private Equity'; 'Private Equity Demystified').

OUR **PE BLOG** SERIES COVERS A NUMBER OF TOPICS THAT MIGHT BE RELEVANT FOR YOUR BUSINESS.

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21-01-2190