



## A Guide to Raising Private Equity

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## A Guide to Raising Private Equity

### 1.1 Introduction

Raising private equity can be a time consuming, expensive and unforgiving process for the potential investee company. Like all specialist areas, venture capital has its own set of guidelines and rules, often unwritten, and largely brought about from previous experience of the funds and the managers themselves. The purpose of this Guide is to demystify the fund-raising process and identify the key areas and issues involved in raising private equity.

### 1.2 Meeting the investment criterion

Prior to embarking on this process of raising private equity, it is important to determine whether a proposition fits the profile of a typical private equity investment. In judging the investment fit, there are four important criteria on which a private equity firm places emphasis: the management, past performance, future prospects and exit prospects. This Guide will review each of the key areas in detail.

#### 1.2.1 Management

Private equity firms are in the business of backing experienced and balanced management teams. It is fair to say that a good management team may perform well in a difficult situation but a poor management team is a catalyst for underperformance and failure. Given that most of the venture funds are "hands-off" in their investment monitoring approach, reliance and trust has to be placed on the "day to day" guardians of the investment.

Venture capitalists are wary in backing the "one-man band" entrepreneur for fear of lack of control, an absence of all round skill base and vulnerability to the well being and motivation of just one individual. Similarly, a management team with a history of prior failure are unlikely to raise private equity.

There are of course companies where the founding and dominant shareholder has built up a capable and independently minded team. In such circumstances, the venture capitalist will consider investment.

The ideal management team is an experienced and balanced group of individuals', what does this mean? In looking at the prime age range of a management team, 35 to 50 is the key range. There are of course many exceptions to this age stereotyping band, however most dynamic management teams comprise individuals in this prime career building age range.

In terms of balance, the ideal MBO team is likely to have a high calibre individual covering each of the major management functions; chief executive, finance, production and sales. Where a weakness exists in a key management discipline, a buy-in-candidate can prove to be a useful addition to a management team. The key managers are the chief executive and the finance director. Because of the level of gearing tight financial control is critical to the success of an MBO, and the finance director is a key position.

In larger transactions, a balanced management team is expected and is the norm. When it comes to smaller transactions, gaps can exist in certain management functions where a dedicated role cannot be justified due to the size of the company. Private equity firms understand the need to be flexible when it comes to dealing with smaller investments. However, each key management function needs to be addressed and as the investee company develops, so must the management capability and infrastructure.

In smaller companies, an alternative to recruiting a full-time member of management to cover a particular function is to appoint a non-executive director with experience in the relevant area. Given that venture funds tend to appoint non-executives, this can sometimes prove to be a useful bridge for the smaller company which cannot justify the full-time resource. A non-executive is no substitute for a full-time member of the team, particularly in the area of the finance function. There is a clear limit as to what an individual can do within a time constraint of one to two days each month.

Professional and balanced management teams are therefore a pre-requisite for the venture capitalist.

### 1.2.2 Past track record

Arguably the best barometer to predicting future success lies in reviewing the past performance and track record of a business. Past performance is invariably a further indicator of the qualities of the incumbent management team.

Often the MBO gives management an opportunity to have freedom of thought and action and be owner-managers for the first time. This tends to stimulate motivation to improve on past performance outside the cloak of the parent company. Therefore the MBO can transform an underperforming company's fortunes by having a more committed management paying closer attention to some of the following areas.

- (a) rationalisation of the overhead, both central and divisional, which may lead to a realisation of additional profits and improved performance;
- (b) improvements in product innovation and approach to marketing;
- (c) investment in new capital equipment which was previously denied by the parent company.

The above examples are but a few of the many improvements that can take place, post MBO. To convince a private equity firm of the improvements, the management team will also need to explain why the improvements were not implemented in the past.

In reviewing ways to improve past performance the venture capitalists will be influenced greatly by the following factors:

*Maturity and prospects of the industry* Clearly a company forecasting to trade in line with the industry overall is prima facie more credible than a company anticipating growth ahead of the market.

*Changing nature of the technology* An industry which has ever-changing technology is likely to require considerable future investment in research and development, continuing capital expenditure commitments and uncertain prospects.

*Production and plant facilities* A business which has underperformed because of poor operational infrastructure has difficulty in raising private equity because of the cost of investment required and the risks that the new investment is not properly managed.

*Competitive marketplace with low barriers to entry* A company which operates in a saturated marketplace, where price-cutting and severe competition are the norm, will cause concern. In the absence of some competitive advantage, the future prospects for the business are unlikely to differ from past performance.

In reviewing rescue or turnaround situations, the venture fund is unlikely to be convinced by a "things will be better tomorrow" scenario. The past has to be explained and quantified and venture capital firms will only consider investing where there have been strong mitigating circumstances.

Start-ups and early stage investment propositions make up 15 per cent of the total number of investments made each year, yet account for only 5 per cent of the total by value. Early stage investments are difficult for private equity firms to invest in since the all important track record cannot be substantiated. In the case of a start-up, often the business plan is the only evidence which a venture fund has available to judge the feasibility of a proposal. The past track record and direct industry experience of management is important in forming a view. The management walkout scenario is most likely to find favour with venture funds, where a management team resign from their former employer and recommence trading as a start-up entity. Providing there are no legal implications surrounding a walkout, this can be a safer way to undertake a start-up venture. The risks being lower: the management team, the product or service and the market have not changed and the forecasts are not dependent on change. Start-ups which require significant capital expenditure or new products or markets are more risky and find fund-raising more difficult.

### 1.2.3 Future prospects

Whilst the past prospects are the barometer, a private equity firm will only benefit as a shareholder from future performance. To attract private equity investment, a company should show progressive growth to enable good investment returns to be generated from dividends and principally on the ultimate realisation of a capital gain. Since the valuation of a company is normally derived from its earnings stream, rising profits are therefore a prerequisite to a capital gain. Similarly from an investee company's perspective, unless significant progress can be made from utilising venture capital, there is little justification in taking the private equity and giving up an equity shareholding.

As a simple rule of thumb, private equity firms seek to make investments that at least will double in value over 3 years, which, with all other things being equal, requires a doubling of profits equating to a compound annual growth rate in profits of 25%.

This simple rule of thumb is illustrated below:

#### Pre-tax profits growth profile

	Growth rate	Yr 0 £'000	Yr 1 £'000	Yr 2 £'000	Yr 3 £'000	<i>Suitable for venture capital?</i>
Company A	5%	500	525	551	579	No
Company B	25%	500	625	781	976	Yes
Company C	50%	500	750	1125	1687	Yes, if believable

In the case of Company A, profit growth and thus capital value growth is unimpressive and is unlikely to attract venture capital support. Company B shows good profit progression and providing a realistic entry price was paid for the initial investment, a good profit would be achieved on an earnings-based valuation. Company C would represent an exceptional opportunity for investment but such rapid growth would need to be capable of reasonable substantiation. Impressive growth as projected by Company C is not necessary to achieve the required venture capital rate of return and setting such high compound growth can lead to subsequent lack of credibility problems when the planned profits targets are not achieved.

In reviewing future prospects, venture capitalists are strongly influenced by factors that are verifiable. Such factors at the micro level include:

- (a) forward order book;
- (b) number of customers and their prospects;
- (c) stability of the customer base;
- (d) patents and trade licence agreements which protect earnings;
- (e) on-going capital expenditure requirements;
- (f) product range, product lives and longevity of the product range;
- (g) reliance on suppliers and their prospects;
- (h) number of competitors and their prospects.

At the macro level, venture capitalists will be interested in three key areas: the industry prospects, technology changes and barriers to entry.

#### *Industry prospects*

A company operating in an industry which is in decline or in a stagnant phase will warrant closer scrutiny to demonstrate profit growth and upside potential. Clearly in those industry sectors, profit growth dependent on cost reductions rather than revenue increases is likely to find stronger venture capital interest. Arguably there are no such things as good and bad sectors when it comes to venture capital, instead there are good and bad investment opportunities within each industrial sector.

Ideally a fund manager prefers to back growing companies in growing market sectors, where rapid upside can be achieved, perhaps regardless of management capabilities.

#### *Technology changes*

Today's high technology companies in areas such as information technology and biotechnology represent high return opportunities for venture capitalists. For such emerging technologies the related risk factor is equally high, particularly in the areas of start-ups and early stage investments.

Invariably the time, effort and cost of developing a product then launching onto the marketplace takes longer than budgeted for. Many venture capitalists treat this area as a cash black hole and avoid such companies. By contrast, specialist high tech funds concentrate on those opportunities. A factor for those venture funds to consider is the longevity of the product; particularly where an industry is prone to frequent change.

#### *Competitive barriers to entry*

Private equity funds are more interested in companies which have barriers to entry as the barriers reinforce the predictability of future earnings. The following are barriers that prevent new competitors from entering the market:

*High capital entry costs* An industry which requires significant plant and machinery to enter the market acts as a defence mechanism.

*Patent/copyright/government approvals/product brands* All of which act as a barrier to entry given the time and cost of their creation.

*Niche companies and specialisms* Companies which have a known specialisation or specifically operate in a smaller subset of a marketplace can demonstrate an element of competitive advantage.

The private equity fund manager considers all micro and macro variables in determining whether future profit prospects are achievable.

### **1.2.4 Exit prospects**

Given that most private equity firms raise their funds through 10 year limited life partnerships, the schedule for a typical venture capital investment is to exit in around 3 to 7 years. The captive private equity firms can claim to be longer term, however, all private equity firms are driven by the need to generate capital gain so as to maximise the investment returns. Because of this, investee companies wishing to attract venture capital must have in mind an exit within this timeframe, investment offers from venture capitalists often contain incentives and/or penalties to encourage exit. For example, increasing dividends or reducing equity shareholding mechanisms can be used to force the exit.

The focus on exit prospects is simply financial: exits produce investment returns, proving the performance of the private equity fund managers. Good fund performance will make fresh fund raising easier and the financial rewards to the managers greater.

In assessing the exit prospects the venture capitalist considers the following routes:

#### *Flotation of the company*

Until the emergence of the Alternative Investment Market (AIM), the prospect of a full flotation was limited to all but a few investee companies. The large, fast growth and high profile company can lend itself to a flotation and many private equity investments have subsequently floated on the stock market.

Flotation represents a logical exit point for the venture capital provider, giving the flexibility of a complete exit or of a gradual exit of publicly quoted stock over a period of time.

#### *Trade sale*

The majority of venture capital investments are exited by way of trade sale to a third party company. Unlike flotation, a trade sale can be quick and a relatively certain route providing the company has demonstrated a good track record, post private equity investment.

#### *Share buyback*

While the option can exist for an investee company to buy back their venture partner's shares, there are two main practical difficulties which have restricted these exits: an unwillingness by the private equity firms to participate in these arrangements, driven by suspicion and the problem of funding.

*Private equity suspicion* In these arrangements, effectively the other shareholders become buyers and their economic interests are best served by paying as low a price as possible. Consequently, private equity firms are anxious to avoid being misled as to the value of their shares.

There is always the worry for a venture partner that a 'back to back' deal has been negotiated by management with another prospective purchaser.

*Fundability issue* The issue of funding the consideration has to be overcome, which is likely to involve at least raising additional debt and may also require additional equity funding from a replacement equity provider, venture capital or otherwise.

#### *Secondary purchase*

This route is becoming increasingly more common in larger transactions. The new venture capital partner route can work particularly well where the old venture partner is forcing an exit to meet their own investment criteria preferences while the management believe that further growth potential exists giving rise to a logical exit a few years further on. Secondary purchases can be attractive to investee companies where the relationship with the old partner has broken down irretrievably or that private equity fund does not have sufficient financial 'firepower' to commit to further rounds of investment in the development of the investee company.

### **1.3 Matching the fund to the proposition**

The BVCA maintain a directory of members on their website [www.bvca.co.uk](http://www.bvca.co.uk). This lists private equity firms, their investment preferences and contact details.

The following are six main criteria to consider when matching a proposition to a fund.

#### **1.3.1 Size of investment**

All the private equity funds can be differentiated by the size of their preferred investments. However, equally, all firms tend to be flexible in considering opportunities, focussing on the size of the potential financial gain as well as the initial investment.

There are over 10 UK private equity firms each with funds of over 1 billion Euros; for those funds, average equity investments will need to exceed £30 million.

There are also a large number of mid-market firms seeking average equity investments of £10 million to £20 million. Even the smaller to mid-market corporate funds will have a target minimum equity investment level of £2 million and an average of £5 million.

Funding requirements below £2 million are increasingly becoming the domain of the venture capital trusts, government supported regional funds, business angels or private investors. So, at present, a real equity gap exists in terms of the provision of 'professional' private equity in the sub £2 million market.

For practical purposes, the private equity firms provide funds in three distinct segments of the market, namely:

- (a) large buyout funds, investing in excess of £30 million of equity;
- (b) mid-market firms, investing £10 to £20 million of equity;
- (c) smaller cap investing £2 to £5 million.

Transactions outside the ranges can also be syndicated by firms allowing them to lead on larger transactions. Syndication is where more than one private equity firm will be investing in the deal, usually with one private equity firm acting as lead investor and the other investors following.

Business angels are probably the largest source of smaller amounts of private equity.

### **1.3.2 Stage of investment**

Most of the private equity firms do not invest significantly in early stages, start-ups and turn-around investments because the historic investment returns are the lowest by category for the venture capital industry. Because of this adverse past experience, the higher risk type investments tend to find fewer venture capital suitors. Invariably early stage and start-up companies also relate to smaller investment propositions, and as such tend to be avoided by the primary funds.

Furthermore, the funds have been raised from institutional investors to invest in buy out opportunities and specifically not to invest in early stage opportunities.

### **1.3.3 Industry preferences**

Whilst there are no such things as good and bad sectors, most of the private equity firms will have favourite 'pet' sectors at any point dependent on their personal experiences, the demands of their investors and market perceptions.

Generally, most venture funds work to achieve a balanced portfolio across differing sectors. This approach tends to insulate funds from a sporadic downturn in a particular sector and fits in with the primary objective of a portfolio, which is to balance risk. Clearly the larger the fund, the greater the opportunity to make more than one investment in any sector.

The last point has important connotations for would be investees in that it is important to check whether a venture fund has an existing concentration of investments in the potential investee company's sector.

In order to research investment portfolios of the various funds, the *British Venture Capital Association* is a useful source. There are some funds which do abstain from disclosing their portfolio and 3i is one such fund due to the sheer size of its portfolio. Each fund tends to have sectors of particular interest and individual fund preferences are disclosed in the BVCA Handbook and on websites. Many of the generalist venture funds avoid property deals, financial services and gambling, the latter often being a requirement of US institutional investors. Many private equity firms will also avoid 'people based'

business. The risk of 'people businesses' being twofold: firstly, the assets literally do walk out the door every day and secondly there are often no barriers to entry for new competitors.

Most of the generalist funds avoid high tech propositions which relate to such areas as biotechnology and information technology. The expertise required to understand such propositions is not suited to the generalist fund manager and usually rests in the domain of high tech specialist funds. Indeed many of the high tech propositions come under the category of early phase investments and much of the skill in making money in this area lies in exploiting new ideas and innovations, many of which are not at a stage of production, and are little more than a concept. The specialist high tech funds are the exception to the principal that venture capitalists avoid early phase and start-up investments.

Whilst avoiding early stage investments, it is also true that all funds are attracted to investments in fast-growing sectors – because fast profit growth is the key driver to faster capital growth and capital value growth is the aim for private equity investors.

#### **1.3.4 Geographical preferences**

Several private equity firms have offices across the UK, with some cities better served than others. Most of the private equity firms remain focused on the UK, but commitments made during fund raising have required the private equity firms to seek opportunities in continental Europe. These commitments have largely been driven by the requirements of US investors who believe the UK is over-supplied and continental Europe is under supplied. Over 20% of total private equity investment raised by UK private equity firms is invested outside the UK and several of the private equity firms have offices located abroad.

Most of the regions in the UK will also have their own region specific funds, who focus resource and effort on seeking local investment opportunities, again this focus being driven by investors.

#### **1.3.5 Degree of involvement**

In choosing a private equity partner, it is not only important to know whether their house style is 'hands-on' or 'hands-off' but also how "hands-on" the "hands-off" style is. Almost all UK private equity firms subscribe to the hands-off approach which is to let management teams operate the company with minimum involvement by the venture partner in the day-to-day running of the business. A 'hands-on' approach tends to involve a fund taking a more executive director orientated approach, installing their own executive management, or in the smaller secondary funds having a direct involvement.

Fortunately, for investee companies, the majority of the private equity funds back the judgment of management teams to run a company. The private equity fund manager's job is to source, execute and realise investments and not to run businesses, and they do not have the resources to be directly involved. For this reason, all private equity funds appoint non-executive directors to represent their interests at company board meetings. The typical profile of a non-executive is an individual who has experienced a successful career to date at senior management level and who now has sufficient spare time to add value to a company, typically one to two working days per month. The non-executive appointment is designed to give a management team an external and independent perspective using a breadth of experience gained over many years in industry and commerce. The non-executive also represents the interests of the venture capital fund in decision making but can be expected to act in the best interests of all the shareholders.

As part of the normal investment monitoring process, the private equity fund will usually appoint one of their executives as a non-executive or as an observer to the company. The executive will usually visit the company a few times each year to remain close to the investment. In addition to occasional visits, most private equity firms require regular management accounts, cashflow forecasts and other financial information. This information is normally produced in agreed formats and to set timetables.

When an investment is going well for management and investors alike, an investee company will have minimal involvement from the venture capitalists. But if an investee company starts to miss budgeted performance, then the variations in "hands-off" will become more apparent. Most private equity firms will act to protect their investment, the variation comes in the timing of action and the actions that would

be taken. Usually if an investee company falls into arrears on capital or dividend repayments, the articles of association will allow the venture capitalist to take a more active involvement. This is often effected by changes in voting control triggered by the arrears. This is often a concern for management, however, most private equity firms will rely on the judgment of the management team they originally backed, and when the company experiences difficulties venture capitalists are, by and large, very supportive.

All private equity firms will restrict the management team in such areas as directors' remuneration and benefits, sizeable capital expenditure decisions, and ability to transfer shares or elements of the business outside the investee company or its related subsidiaries. For the management team which is prepared to abide by the spirit of the investment agreement, such measures should not prove to be unnecessarily restrictive and would have been discussed and agreed in detail prior to completion.

### **1.3.6 Length of investment**

Most private equity firms are motivated to achieve a capital gain from their investments within 3 to 7 years. This effectively means that an investee company, at some stage over the life of an investment, will have to contemplate a disposal of the company or provide an alternative means for the venture capitalist to realise a capital gain. Therefore management shareholders who wish to remain or grow family dynasties are unsuited to venture capital.

In the management buy-out, the management team are usually equally enthusiastic to achieve an exit in order to create personal financial independence. Family owned businesses with years of tradition and family heritage will have to convince a private equity firm, they can embrace an exit requirement if they wish to raise venture capital.

## **1.4 The fund-raising process**

### **1.4.1 Role of the financial adviser**

The role of the financial adviser is to advise on the types of funds, typically debt and equity, the mix of those fund types and to effect introductions to the best providers of those funds.

The success of any fund-raising is dependent on the quality of the investment opportunity, and is also dependent on the quality of the guidance and advice given by the corporate finance adviser.

The adviser will be active in packaging, presenting and representing the client in the fund-raising marketplace from inception of a transaction to its ultimate completion. The process will involve advice on valuation, the requirements of the various investors, negotiation with the investors and advice on the overall capital structure. In selecting an adviser the client should focus on the adviser's credentials.

The best corporate finance advice comes from those organisations with an experienced 'hands-on' approach. The emphasis on experience is to match funds with opportunities and creating the right blend of funds. Inexperience will lead to fruitless activity and at worst, least to failure. A 'hands-on' approach is necessary to ensure that information and financial forecasts are tested before exposure to the rigours of due diligence. The role of the financial adviser should also include client representation and support at all meetings and to pro-actively co-ordinate and negotiate with all parties at all stages up to completion.

### **1.4.2 The role of other advisers**

In concluding a private equity transaction the investee company is also likely to engage a tax adviser and a solicitor. Their roles are outlined below

#### *The tax adviser*

The tax adviser will help to ensure that all possible tax reliefs are maximised with attention likely to focus on: obtaining tax relief on interest paid, personal capital gains tax planning and advice on the tax relief of the costs incurred in connection with raising private equity.

### *The solicitor's role*

The solicitor will advise on the warranties and indemnities sought by the private equity investor, the service contracts for managers and the articles of association required by the private equity firm.

### *Other advisers*

In addition to the investee, the private equity firm will also be appointing professional advisers to conduct financial due diligence, legal due diligence and to prepare the legal documents required to document and protect their investment.

### **1.4.3 The business plan**

The business plan is the first point of contact with the business for the private equity firm. First impressions are crucial. It is recognised that many good investment opportunities may be passed over principally due to quality and content of the original proposal document sent.

It is important to achieve a 'clarity' and 'brevity' which invariably is contained in 'sharp and punchy' documents. The 200 pages of narrative, graphs and pictures is unlikely to find a willing reader prepared to write off half a day for a first read. Similarly, a marketing type plan which contains plenty of narrative yet contains one page on the financials and the funding requirement, will find little favour.

The plan must be written in a concise and understandable manner. Because of this, it is sensible to have any document 'proof read' and edited by a financial adviser. The adviser should be experienced in preparing documents to the required standard.

The purpose of the plan is to document the business and outline clearly and persuasively the investment opportunity being offered.

### *Steps to producing a business plan: a guide*

*Step 1: Prepare an evidence file.* Produce an evidence file covering detailed information on the following areas, where appropriate:

- (a) concept and business explained
- (b) market opportunity and growth prospects
- (c) explanation of past track record, financial and otherwise
- (d) product range(s)
- (e) customer profile
- (f) competitor analysis and barriers to entry
- (g) sales and marketing strategy
- (h) sales process from start to end
- (i) production process from start to end
- (j) capital expenditure requirements
- (k) market data and research information
- (l) management team CVs
- (m) organisation chart
- (n) strengths, weaknesses, opportunities and threats (SWOT)
- (o) statutory accounts for the past five years
- (p) copy of the memorandum and articles of association
- (q) copy of any relevant lender facility letters.



*Step 2: Prepare a financial assumptions file.* Produce a financial assumptions file providing base data for the assumptions used to construct a detailed financial model. The following major areas, where appropriate, will need to be covered:

- (a) sales assumptions by product volumes and unit selling price; in a manufacturing company it is also necessary to relate sales to production capacity and plant utilisation levels;
- (b) the impact of seasonality on the business: on sales and working capital, the impact of holidays and shutdown periods and the number of working days in a month;
- (c) relate cost of sales components (eg. direct materials) to sales;
- (d) analyse sales by customer and forecast prospects for three years;
- (e) work out required payroll numbers and specific salaries/pay rates to accommodate planned sales;
- (f) quantify and specify overheads by caption, whether direct or indirect;
- (g) review capital expenditure requirements over the next 3 years;
- (h) analyse stock and work-in-progress levels and relate to sales activity;
- (i) analyse debtor and creditor days, historically by month;
- (j) quantify all lender and hire purchase repayment profiles.

Using the preliminary work carried out in steps one and two, a clear understanding of the business will have been achieved. The next steps are to produce both the financial model and the written document.

*Step 3: Detailed financial model.* A 3 year financial model is required which is capable of producing monthly profit and loss accounts, monthly cashflow statements and monthly balance sheets. The monthly financial statements should be supported by integrated workings covering each of the major areas highlighted in Step 2. The monthly cashflows will pinpoint peak funding requirements, which will then have to be met by an appropriate funding structure. In reviewing the corresponding monthly balance sheets and the interest cover levels as shown in the monthly profit and loss accounts, the debt capacity level of a company can be calculated, leaving any funding shortfall to be fulfilled by private equity, and/or deferred vendor consideration.

*Step 4: Prepare the business plan.* The business plan should be a succinct and stand-alone document, presenting a cohesive investment case, consistent with the financial model. The business plan should incorporate a summary of the annualised projections and contain a dedicated section on the funding requirement. The document needs to "stand alone" providing readers with sufficient information to evaluate the opportunity. It is best to avoid the use of superlatives and statements which are not capable of being substantiated and should chart a cohesive story without unnecessary duplication. At most, excluding the financial section, it should consist of 20 to 30 pages. The detailed financial model should be supplied separately. Arguably, if it takes more than 30 pages to convey a concept it may indicate that management are incapable of demonstrating a convincing and succinct argument. Irrespective of this argument, the private equity manager is unlikely to invest the time in assessing a larger business plan.

*Example – a suggested contents index*

A business plan should typically contain the following types of section:

*Summary of proposition* – an introduction to the opportunity, an outline of the business and the funding requirement.

The summary should also give an indication of future and past profitability and make a comment on the experience of the management team. The summary should be a stand-alone section briefly outlining the complete story.

*Nature of business* – a description of the industry and an overview of the position of the business in that industry. An assessment of the market and the competition, dependency on suppliers or customers, barriers to entry, the pace of change, the prospects for the industry and the business within it.

*Financial summary.* From the past audited accounts and the detailed financial model give a summary of the profit and loss accounts and the balance sheets for the past 3 years and the future 3 years.

In addition a summary cash flow statement summarising the inflow and outflow of funds is also required. The cash flow statements should clearly show the movements in working capital and historic levels of depreciation and capital expenditure.

It is important that all three statements: profit and loss account, balance sheet and cash flow statement should reconcile with one another. If it is important to adjust the past results to exclude exceptional non-recurring items, the adjustments should be clearly explained and documented in supporting schedules.

The commentary should describe the historic trading performance and the key assumptions used to prepare the financial model. Sensitivity analysis showing the effect of varying important assumptions should be shown in a stand-alone appendix.

*Finance required and purpose.* The financial model should be capable of pinpointing funding peaks and troughs and of identifying the optimum capital structure.

#### *Management team*

Given that management is a critical element of any investment assessment, a summary paragraph or two on each senior member of the management team should be included. A factual account of experience and past career is required with the full curriculum vitae kept to the appendices.

#### *Business detail*

This section should provide further depth on the business, concerning the detail that gives a complete picture of the business. It should cover:

- (a) products and customers
- (b) market position and competition
- (c) management and employees
- (d) premises and facilities
- (e) fixed assets, production processes and required capital expenditure
- (f) intellectual property, trademarks, goodwill and other intangible assets
- (g) contingent liabilities
- (h) SWOT analysis

The business detail section is one that can clearly be supported by pictures and graphs. The key with graphics is to illustrate the text, too many graphics will disrupt the flow of the text.

In the SWOT analysis it is important to be objective on the weakness and threats since a business proposition which is all strengths and opportunities would imply a lack of realism or understanding of the marketplace.

In summary, there is no right or wrong way to write a business plan. Whilst the plan is written by management it is being read by fund providers, and their needs are the ones to be satisfied.

#### 1.4.4 Fund-raising in the marketplace

##### *Phase one – preparatory stage*

The preparatory phase requires the management team to finalise and know their business plan, to prepare for subsequent meetings with funders and to select the funders.

*Know the business plan.* It is important for management to know the plan inside out. Management must take ownership of the document, even when it feels like the corporate finance adviser has written the plan on behalf of the management team. The management must know the key assumptions which make up the finance model and the basic profile of the key numbers over the forecast period.

It is damaging to fund raising if, members of management make statements which do not tie into the plan. The funder is left with the dilemma of clarifying whether the statement or the plan is correct, or whether both are wrong.

*Prepare for the meetings.* It is important that a management team interacts effectively with each other, with each team member assuming responsibility for their own particular discipline.

It is useful to undergo a full dress rehearsal of a meeting with a private equity firm. These sessions should enable the management team to perfect their presentation and also provide useful experience of the question and answer sessions used by private equity managers.

In dealing with questions, it is important not to become defensive or give an answer which is not capable of being substantiated.

When giving answers keep them short, sharp and factual. Shorter responses allow more ground to be covered in the meeting and also keep the interviewer on their toes. Still on the subject of interview technique, expect most of the questions to be asked as open questions requiring a detailed response rather than a simple yes or no type answer. Venture capitalists are also well schooled in the use of silences.

*Select the funders.* The different characteristics and preferences of the various private equity firms are explained in 2.3 above. This role of the corporate finance advisors is to guide the management team on the selection of funds to be approached.

While many of the private equity firms use relatively similar investment instruments, terms and conditions can and do vary considerably.

##### *Phase two – the initial market phase*

The fund or funds to be approached will normally be contacted initially by the corporate finance advisor. The aim of this contact will be to prime the private equity firm as to the nature and quality of the opportunity. The business plan is normally then forwarded in advance of a meeting. In this initial period it is unlikely that the private equity firm will invest significant time to the proposition other than to consider the plan submitted.

*The first meeting.* At this stage the private equity manager will be keen to expand on the content of the plan and a series of open questions will be asked to test their own and management's understanding of the business and the key issues. In particular, management will be closely scrutinised at the meeting since the success of a proposition ultimately depends on the management team, and therefore on their preparation for the meeting.

The approach of each private equity firm is down to the individual fund managers concerned. However, all the fund managers regard personal chemistry as very important since a great deal of time is spent with a management team in the run up to completion and often beyond. A good meeting is often signalled when a fund manager switches from buyer to seller. This is when the fund manager starts to talk in detail about his fund, firm and why it is best suited for the investment opportunity.

It is probable that a fund manager will finish a positive meeting by proposing to sponsor the proposition to the other fund managers of the private equity firm with a view to canvassing support to proceed to the next stage.

*The internal case review.* Each week most private equity firms hold internal meetings to talk about their investment opportunities. The purpose of these meetings is for the various managers to determine how these various opportunities should be pursued or abandoned.

At these meetings all senior managers of the fund are likely to be present. At the end of this case review process, the decision is taken to continue on an agreed basis or to reject the proposition. The internal case review meeting does not normally mean board approval, but instead represents informal support to move the proposition towards formal board approval stage, in due course.

#### *Phase three – Getting to conditional offer*

Assuming, the proposition is of interest, the fund manager will be keen to become fully familiar with the business and its management prior to issuing an outline offer letter. This period of due diligence may include taking references on the management team. Referees will be a combination of direct business acquaintances and past employers. Deals do fail to attract funding, because of poor references, as management credibility is of paramount importance. Before completion all the private equity firms will take out full references on the management team, possibility utilising 360° feedback and psychometric testing and analysis.

Other due diligence work undertaken by the fund prior to completion will include the taking of customer references and possibly commissioning a market report to review the industry sector and the issues which it currently faces. At this stage it is likely that the assumptions contained in the financial model will be scrutinised in some detail, prior to full due diligence being undertaken by investigating accountants.

This phase is characterised by a great deal of information flow from the management to the private equity fund manager. Essentially it is a due diligence exercise conducted without external cost to the private equity firm. A deal is far from secure at this stage and the only commitment made by the fund is to devote time to further consider the proposition.

At the end of this phase, the venture capitalist will issue a conditional offer letter summarising the terms for any proposed investment, this will be subject to their own investigations and the management's business plan standing up to third party due diligence.

The offer letter will contain an intended funding scheme, the funding instruments proposed and the required dividend or interest yields and equity rights.

The approach to offer letters varies between private equity firms, in terms of content and internal approvals required, they are however, usually consistent in seeking exclusivity.

#### *Phase four – Getting to completion*

This fourth phase involves working exclusively with a preferred private equity fund, to eliminate their pre-conditions, completing their due diligence and ultimately concluding with their investment.

The pre-conditions are likely to include satisfactory management referencing, keyman insurance and market reports.

There will be a condition precedent that all other required sources of finance are in place by completion. In the case of a management buy-out, it is important for management to source all personal funds required for investment at completion. Some of the conditions precedent will relate specifically to the proposition and may for example cover the need to have all registered approvals and patents prior to completion. The conditions precedent are designed to highlight key areas which are required to be satisfied prior to completion.

The due diligence will include legal due diligence to confirm that the business has all the required assets and rights to trade as planned and to confirm that all potential and contingent liabilities have been disclosed and assessed.

Similarly, the venture capitalist will require an investigating accountant to review and comment on the assumptions used to prepare the financial model.

The review of the financial forecasts is designed to test the reasonableness of the assumptions applied and, where appropriate, compare them to past performance. Validating the integrity of the financial model, increases confidence in the funding requirement intimated and the funding instruments applied to meet that peak requirement.

As part of this process, the investigating accountants will carry out a sensitivity analysis on the key variables to determine the effect on funding requirements and the profit forecast of key changes. The sensitivity analysis is designed to identify the pivotal points of change which make the business proposition untenable.

In addition, the investigating accountant will focus on other risk areas, as directed by the venture capitalists. These risk areas might include:

- (a) adequacy of stock valuation methods used and the accounting treatment applied to work-in-progress;
- (b) an assessment of historic and future working capital requirements;
- (c) comment on the trends in sales and costs;
- (d) the accounting policies adopted by the company.

The investigating accountant is also likely to be instructed to assess the adequacy of financial systems and controls which the company has in place.

## **1.5 Choosing an investment offer**

Often, management teams will have to choose between competing offers from private equity firms. The decision usually rests on the economic arguments, but it is important to consider other issues such as deliverability, personal chemistry and access to further funds.

*Investment offer terms and conditions.* The ordinary equity percentage required by the venture capital fund is usually the most important consideration, since this element is likely to be the most material element of the cost of the private equity. In MBO situations, the subject of equity can become complex with the introduction of performance ratchets, which require a formula to be applied in calculating the final management equity stake.

The other terms will deal with dividend or interest rates, the repayment profile of the preference shares and/or any loan instruments and the extent to which an exit is encouraged by penalties, in the form of rising dividends, or rewards in the form of increasing management equity stake. The three constituent components of equity percentage, dividend yield and repayment profile, can be assessed with a discounted cash flow model to provide a uniform basis for comparing different offer letters.

*Deliverability.* It is important to ensure that the private equity firm can complete the deal on the terms intimated and within the required time.

To avoid any doubt, it is best for management to agree with the venture capitalist a detailed schedule of events from offer letter stage through to completion.

*Personal chemistry.* The management team should have some personal chemistry with their intended equity partner. A good working relationship between management and the fund provides a stable platform on which to develop the company.

A potential investee company should not be afraid to ask for references on the fund concerned, which usually entails speaking directly to other investee companies of that fund.

In reality, most investee company relationships are good with their venture partner, particularly where an investment is performing well. It is when a company is doing badly that the worst effects of a bad relationship can be most felt which can, in extreme situations, have direct consequences for members of the management team.

*Access to further funds.* When deciding on an investment partner, it may also be important to assess both their willingness and ability to inject second round funding. When dealing with a smaller fund, it may be difficult for that fund to commit significant additional investment, particularly in a rescue situation.

## **1.6 Key points**

### **1.6.1 Meeting the investment criterion**

- (1) Private equity firms prefer to back a balanced and experienced management team.
- (2) In assessing investment propositions, venture funds are influenced by the past track record of a business, as a guide to future profitability.
- (3) The private equity firm's assessment of the business future prospects will determine their investment terms.
- (4) The exit timeframe for a typical venture capital investment is around 3 to 7 years maximum, and most pre-investment analysis focuses on the year 3 prospects.

### **1.6.2 Matching the fund to the proposition**

- (1) Given the historic investment results and the costs associated with making smaller investments, private equity deal sizes continue to rise with the majority of equity investments being at least £2 million.
- (2) Most private equity firms will not invest in early stage opportunities. Historically, the investment returns have been higher in larger management buy-outs and most private equity firms focus on these opportunities.
- (3) Most of the generalist private equity firms aim for a balanced portfolio across sectors, but prefer high growth sectors.
- (4) The investment requirements of the private equity funds are driven by their fund providers the majority of which are US based investors.
- (5) The investment management approach of most private equity firms is "hands-off", leaving the day to day control of the investee company with the management team.
- (6) Long established and family owned companies may find venture capital to be a "bridge too far", given the need for a fund to achieve a medium term exit.



**1.6.3 The fund-raising process**

- (1) The role of the financial adviser is to advise on the types of funds, the mix of funds and the best providers of those funds for the investment opportunity.
- (2) There is no "right" business plan – the key is to produce a document that encourages the reader to invest, after carefully balancing all the risks and opportunities.