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The owners guide to private equity



BDO Stoy Hayward

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Introduction

The growth in private equity and venture capital funding has been phenomenal. With more money than ever looking for a home in growing businesses, owners seeking finance have never had a greater opportunity to access these funds to develop their business or realise value.

This booklet provides a practical overview of private equity for owners of growing and profitable businesses. Exploring the options will help you identify whether private equity can help you. It also looks at how private equity deals are structured, what to expect from the process and suggests some actions you can take to make your business case attractive to private equity investors.

This booklet is written as a general guide and is not a substitute for professional advice. You are recommended to obtain specific professional advice before you take any action.

Case studies have been used where appropriate to illustrate the way in which some deals may work. In all cases, names and values have been changed in order to preserve client confidentiality.

Much will depend on whether you wish to continue your involvement with the business or make a clean break; and whether you wish to retain a shareholding or sell outright.

Exploring the options

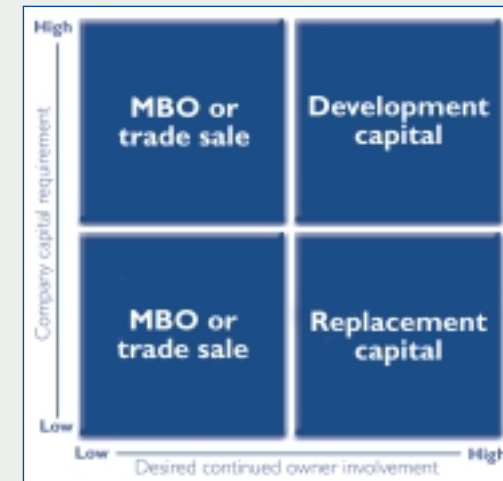
The deal you strike will determine the future of your business and your own family's financial well-being. It is imperative that you structure the deal to provide the right balance of corporate and personal benefits.

Deal strategy

Much will depend on whether you wish to continue your involvement with the business or make a clean break; and whether you wish to retain a shareholding or sell outright.

If you decide that now is the time for you to move on to new challenges, the right decision may be to sell completely. A trade sale could be the solution, but you should also evaluate the potential for selling to a private equity house. For example, if the business has a promising future and strong management, a private equity-backed management buy-out could work.

Private equity: some strategic options



The company's capital requirement, and your continuing involvement in the business, are key factors in shaping the deal.

If you are ambitious for your business, and believe in your team, development capital may be available to take it into the next phase of growth. If you are committed to growing the business but need to realise some value for yourself or other shareholders selling part of your stake in the company could be the answer. You may be able to sell a stake to a private equity house. This replacement capital will enable you to realise some value now and stay in for the opportunity of further capital gains in the future.

Case study one :
The importance of looking at yourself in the mirror

Jack Hayward had grown his business, Hunter plc, from scratch. He owned 65% and turnover was on target to hit £50 million. A highly professional manager was operating as Chief Executive, with Jack acting as Executive Chairman. Jack enjoyed a comfortable lifestyle, and he spent the summer reviewing his options. He was not ready to sell 'his baby' and also felt that this would be unfair to the Chief Executive. At the same time, an IPO (flotation) had limited appeal – not least because Jack did not feel he would be able to sell himself or Hunter to the stock market at this stage of its development.

Although Jack's faith in Hunter's growth prospects was unwavering, he was beginning to feel that his contribution to this was starting to diminish.

The chosen solution was a re-capitalisation of Hunter involving a private equity player. With his advisers, a deal was designed and marketed to a carefully selected group of private equity houses. The response from the marketplace was excellent. Jack sold a 30% stake for cash and retained a significant 35% stake allowing him to participate in the future upside.

Replacement capital or 'Money-out'

What if the timing for a sale is wrong? Suppose you want the financial security that a sale would bring, but you also see exciting potential for your business going forward that you don't want to give up. A partial sale could be the answer. Trade buyers are unlikely to be interested in this type of deal, but private equity and bank backing may be available if your growth story is convincing. It may be possible to obtain private equity that enables you to remain in control of the business while realising immediate value and retaining a stake to enjoy future gains.

You might see this type of 'money-out' or replacement capital transaction as de-risking your investment. Or, it could be that your company has income-driven family shareholders whose interests do not fit with your desire to invest in the business and grow shareholder value. Using replacement capital, you could buy out such shareholders and re-align the interests of owners and management.

It is also a useful way to deal with family succession issues such as a retiring parent who wants to realise value and a different generation who want to grow the business.

For a money-out deal to succeed, you will need a strong appetite for the challenge and the ability to convince investors that you will remain fully committed to the business in spite of your new-found wealth.

Development capital

You see the potential for growth. A slow and steady strategy might mean you miss the opportunity but an aggressive strategy requires substantial up-front investment. Bank loans can take you so far and your own resources may not be enough. You don't want to over-extend your financial commitment and are mindful about your family's financial security.

Private equity can energise your business by providing development capital to fuel business expansion and earnings growth.

Development capital involves introducing new funds to the business for the issue of shares. It usually makes sense to own a smaller slice of a bigger pie, especially when you remain in ultimate control of your business. With private equity and a fast track growth strategy, you have the opportunity to realise substantially more value from the ultimate sale of your business than going it alone.

There may even be potential to realise some value by combining development capital with the sale of some of your equity.

Selling to your management

Like most entrepreneurs, you probably see your company as the embodiment of the risks you have taken and the effort that you have put in. Your strategy for realising value is key to securing the proper rewards for this. Private equity can be an excellent means of realising value for shareholders. With strong management and a compelling strategy for growth, private equity houses will bid aggressively for the opportunity to invest.

There are several ways of involving your management in the deal.

In a management buy-out (MBO) the business is purchased from the existing owners by its management. Private equity houses favour MBOs because continuity of management reduces the investment risk – if there is a strong management team in place, investing institutions will usually want to back it. Managers also can benefit substantially, because of the opportunities MBOs provide to build personal wealth. And for owners, MBOs are an opportunity to reward management loyalty and its success in generating wealth for the owner.

However, MBOs do have certain disadvantages. Sometimes the possibility of an MBO can deter alternative bidders and result in a lower price. The deal can also be complex and costly to set up, and you may need to be patient while your managers sort out the details. There is always the danger that the process will distract management from the day-to-day needs of the business, as with any sale.

A vendor-initiated management buy-out (VIMBO) avoids some of these pitfalls. In a VIMBO, the owner controls the deal through an auction process. VIMBOs can be highly successful transactions for owners, with private equity houses competing aggressively for attractive propositions. It is also possible to involve trade buyers in this process, so that you let the market decide the optimal buyer for your business.

Selling to a new management team

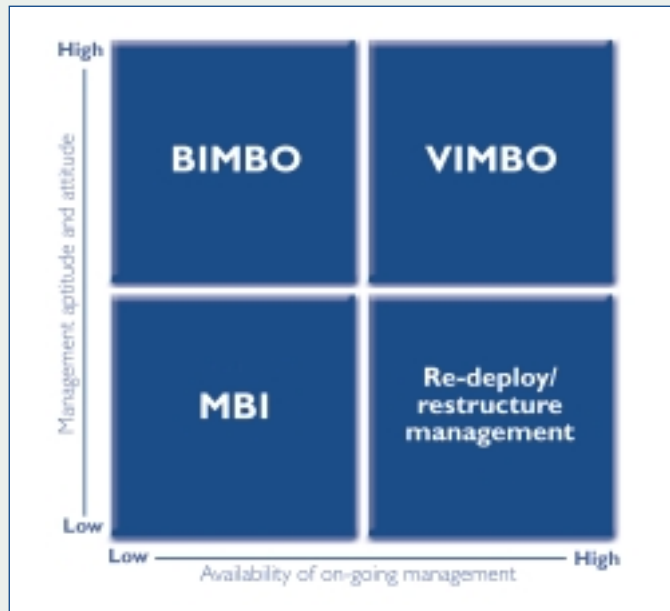
The private equity industry may be able to help you strengthen the team by introducing you to candidates for key roles, or occasionally by bringing in an entirely new management team.

Management buy-ins (MBIs) involve the control of the business passing to an outside management team, typically with private equity backing.

MBIs are much more difficult to achieve than MBOs. Because of the change in management, MBIs are perceived by investors to be riskier transactions than MBOs – the new managers will be unfamiliar with the business and the previous managers may not be entirely forthcoming about all the issues. The additional risk factors can reduce the price a private equity house is prepared to pay.

Buy-in management buy-outs (BIMBOs) are more common than pure MBIs. In a BIMBO, key people are added to an MBO team, perhaps to fill the role of the departing vendor or to strengthen the team. For example, an incoming chief executive and finance director could join an existing team of commercial and operations directors.

The buy-out options



The buy-out options are largely determined by the availability of management and their ability.

What attracts private equity

The massive growth of private equity in the UK has led to a more innovative and versatile approach by investing institutions, all eager and competing to invest in growing businesses.

Whether you are looking to raise funds to invest in growth or to realise value, private equity houses will scrutinise your business from three key angles:

- the potential for value enhancement
- the quality and motivation of the management team
- the exit options which enable them to realise their gains.

You need to prepare your case with care.

Management: the driver of growth

Private equity houses only back the management teams they believe will translate the business plan into reality and generate the required returns – so, the quality of the management team is fundamental. Investors may be wary if your business appears to depend heavily on you as the owner. Some transactions, such as MBOs, will only be feasible if the company has the right people in most of the critical positions.

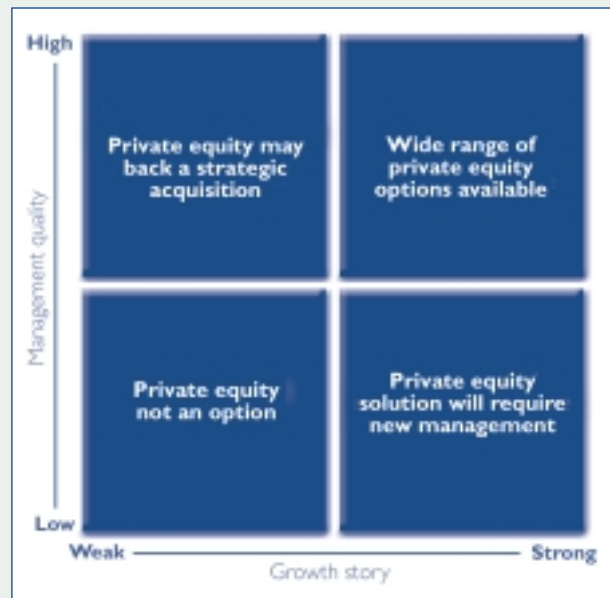
As the leader and motivator, your company's chief executive is usually the key figure in the team, although in some companies the chairman may have a prominent role in driving the business forward. In many businesses the other high profile role is finance director: he or she must have the experience, qualifications and personal qualities to convince a private equity team.

You will also need to have quality people in the other strategically important roles or at least be taking steps to fill these positions. For instance, if yours is a manufacturing business, you will need an effective operations or production director. If it is a retail business, you will need a proven marketing or sales director. If you are an advertising or design agency, you will need a talented creative director.

The combination of a strong growth story with a credible management team is a winner, and private equity houses will compete to invest.

However, you may find that private equity houses are impressed by your business plans but not by your management, in which case they may be able to help you strengthen the existing team.

Private equity: the management/growth matrix



Your company's growth story, together with management's ability to deliver, will determine the availability of private equity.

If you have a weak growth story but an exceptional management team, a private equity house may back a management-led strategic acquisition which adds significant value to and strengthens the growth prospects of the business. As an owner you may recognise this but would prefer to exit the business rather than continue to play an active roll.

However, if you have neither the growth story nor the management, private equity houses will not invest. If you want to realise value you should look for solutions that do not require private equity backing, such as a direct sale to a trade buyer.

Enhancing equity value

Private equity houses aim to achieve substantial capital gains in the medium term. They focus on businesses whose strong growth strategies set them apart from their peers. Private equity houses are ardent believers in heavily incentivising management teams, to deliver increases in capital value. Their deals are structured to ensure that both management and the investing institutions benefit from the capital gains achieved.

Private equity investors also look for opportunities to financially engineer their deals to balance risk and reward by using a variety of debt and equity instruments. So as well as believing in your company's potential for growth, the scope for gearing up their investment with debt is important. By financing part of the investment with debt, the return on equity is increased (see page 17). So expect your forward strategy and financial forecasts to be subjected to rigorous analysis. Before presenting your case to private equity houses, you may wish to seek more friendly external scrutiny from a trusted adviser to get a view on how a private equity houses might structure the deal and the implications this has for you.

Is there a clear exit strategy?

Having taken a view on the management's ability, potential earnings for growth and the kind of financial structure your business is capable of supporting, it will help to demonstrate that there is a clear exit strategy. Even if you are only selling a minority stake now, a private equity deal represents a commitment to a future exit and that can take several forms, such as:

- a trade sale
- an initial public offering (IPO)
- an MBO.

Private equity deals almost always use some form of gearing to achieve the returns required by the various parties to the transaction.

Structuring the deal

In deal structuring various factors will come into play, including the valuation of your business, the types of finance available, the level of gearing and types of debt, and any tax complications.

Valuing your business

Different buyers will place different values on your business. There are various models for establishing indicative valuations, some of which are described in the BDO Stoy Hayward publication, *The Guide to Selling Your Business* (available via our web site at www.bdo.co.uk). Whatever method is used, the business' current and future cash flows and profitability will be central to the valuation. The private equity house will also work back from their target returns to establish an affordable or 'fundable' valuation.

It is essential that you discuss the likely valuation with an independent corporate finance professional at an early stage and prepare yourself for negotiations over value. There could be a shortfall between the valuation you believe is right and the valuation at which private equity becomes available. It may be able to make up the shortfall with some careful deal structuring, including earnouts and altering the relative proportions of different types of finance to better balance the investors' risk/reward profile.

The funding package

The level of gearing in private equity transactions can come as a considerable shock to entrepreneurs, many of whom have built their business around an aversion to debt finance. It is common for debt levels to be two to five times more earnings before interest and tax (EBIT) in MBO and VIMBO transactions, although this depends on the security the company can offer and its ability to generate cash.

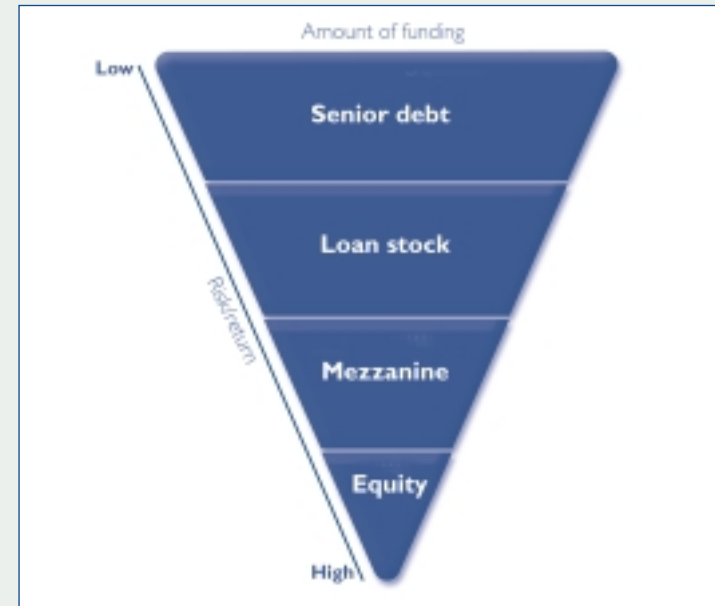
You can expect the deal to contain elements of both equity and debt financing, in various proportions according to the type of deal and business. However, the private equity finance will typically be mostly in the form of so-called quasi-equity, which will have many of the attributes of debt finance – such as a fixed coupon and, usually a set redemption programme.

The different forms of finance have different rights and obligations attached. It usually makes sense for new investors to maximise the cheaper forms of finance, for example bank debt which can be serviced and repaid by the company, and minimise their own equity investment.

These are the most common forms of finance, in ascending order of risk/return:

- senior debt – lending provided by a bank to an agreed schedule of capital and interest repayments with the highest level of security
- loan stock – lending provided by a private equity house with rights to interest. Loan stock has largely replaced preference shares
- mezzanine finance – this is a combined loan/equity arrangement, where the lender may be granted warrants to subscribe for equity at exit
- equity – ordinary shares rank last but offer the highest return if the business performs well, thus providing investors with the opportunity to leverage or gear their return.

A leveraged structure



Equity provides the highest potential for investment returns but also carries the highest risk. Most private equity deals have high levels of bank debt and/or loan stock.

Gearing: the key to success

Private equity deals almost always use some form of gearing to achieve the returns required by the various parties to the transaction.

Private equity houses are likely to demand a return significantly higher than the underlying growth rate in the company's earnings – typically a compound annual return (or internal rate of return) of 25% to 30% for an established growing business and higher for a less developed enterprise.

The private equity house will assess the risk and potential return of your proposition, and 'gear up' the deal accordingly. The greater the risk, the bigger the return they will expect.

In contrast, banks have traditionally focused on achieving an assured return and a high level of security for their loan. However, some banks are now offering combined debt mezzanine and equity funding in the search for more exciting returns.

Case study two: Gearing in practice

Ariadne Limited was set up by Simon Hawkins in 1986, with capital from a number of business angels. Simon held 30% of the equity, the angels the rest.

Three years ago, Ariadne Limited was auctioned to a number of private equity houses, eventually going for £27.8m (the angels receiving £19.5m). The deal also included £1,200,000 of transaction costs, so that the total funding package was £29.0m. Simon was to continue in an operational role for the foreseeable future. The business had just generated EBIT of £4.0m.

The participants contributed to the transaction as follows:

- the bank: £17.5m in senior debt and revolver (together being just over four times historic EBIT)
- the management team: £0.3m in ordinary shares
- the private equity house: £0.5m in ordinary shares and £7.5m in 7.5% interest-bearing loan stock (£8.0m in total)

- Simon Hawkins: £0.2m in ordinary shares and £3.0m in preference shares, which generated a small coupon. His preference shares have similar rights to the loan stock held by the private equity house. Simon also received cash of £5.1m, giving his aggregate consideration as £8.3m – his 30% share of £27.8m.

The ordinary share capital amounted to just £1.0m, of which the private equity house owned 50%, management 30% and Simon 20%.

As a result Simon went from owning 30% to 20% plus cash of £5.1m for his own use plus £3m of preference shares. The company's management had now also been incentivised to deliver capital growth for themselves, the private equity house and Simon. Everything was in place for the company to make a major step change.

Management duly delivered and performance targets over the next three years were met and £7.5m of bank debt was repaid. EBIT rose to £6.0m – an increase of 50%. Ariadne's success prompted a competitor to make an offer, and the business was sold at an enterprise value of £44.0m after expenses. The bank debt and loan stock were paid off first, leaving a balance to be distributed to equity holders. The sale proceeds were allocated as shown as follows:

	Bank	Private equity house	M/ment	Simon	Total
Bank debt	10.0	–	–	–	10.0
Loan stock	–	7.5	–	–	7.5
Preference shares	–	–	–	3.0	3.0
					<u>20.5</u>
Equity	–	11.8	7.0	4.7	<u>23.5</u>
					<u><u>44.0</u></u>

The equity holders were well rewarded for their efforts, at percentage returns significantly above the earnings growth achieved by Ariadne.

The required returns for equity owners were obtained by creating a capital structure with a significant level of debt. This level of debt would probably not have been achievable without the involvement of a private equity house. By investing alongside private equity houses, banks have access to high quality information about the business, such as due diligence reports, enabling them to lend on the basis of projected cash flows rather than the balance sheet.

The equity investors were effectively buying a stake in any increase in value that Ariadne might achieve. By gearing their returns to the rate of growth, the interests of private equity houses, Simon and management were aligned, with all parties motivated to achieve high performance. Failure to grow the business would have resulted in a poor or nil return on their investment.

Legal issues

The documentation surrounding a private equity deal is considerable and at first sight can appear to be a legal straitjacket around the business. However, only poorly designed or negotiated legal agreements will work in this way, at least whilst business is good and in accordance with the business plan. The legal agreements acquire teeth when there is unanticipated material departure from the agreed business strategy, or where covenants are not met. In this case, the private equity house may acquire additional voting rights which swamp those of the other shareholders.

Taxation issues

You will want to structure the transaction carefully to minimise personal and corporate tax liabilities.

If you are cashing in all or part of your investment in the business, capital gains tax (CGT) will be an issue. If the deal is structured to provide an element of cash now and at a future point of exit, you may need to plan for income tax and CGT liabilities.

If the money raised by the transaction is being used by the business to fund its development, there may be corporate taxation issues to consider. For example, interest on bank debt and private equity loan stock is usually tax deductible but dividends on shares are not.

Your interests as the owner may conflict with the interests of the company or other parties to the transaction and some detailed negotiation is usually necessary to ensure that the tax position is optimised to the satisfaction of all parties.

Because the form in which the consideration is taken and the timing of the transaction can have a major impact on your tax position, it is essential that you obtain comprehensive advice from your tax adviser.

There are positive actions you can take to encourage a favourable reception from the private equity industry.

Preparing the ground

Taking some time to prepare for the transaction by developing a convincing case to put to potential private equity partners will be well rewarded.

You will not successfully conceal problems in the business – and it would be a mistake to try – but there are positive actions you can take to encourage a favourable reception from the private equity industry, such as:

- involving key members of the management team
- emphasising your company's strengths
- acknowledging weaknesses and where possible taking measures to address them
- demonstrating that you have a well thought-out strategy for business improvement and growth.

The private equity marketplace is sophisticated and demanding. The case you put forward must have impact, clarity and credibility to be considered.

Understanding the issues

Before you talk to private equity houses, make sure you have a full grasp of the issues. Although a complex area, private equity houses will want you to have thought hard about the likely value of the business and your preferred deal structure.

In particular they will expect you to have:

- a thorough understanding of the state of your company and a full grasp of its financial, taxation and legal affairs
- knowledge about your team, customers, suppliers and market competitors
- an understanding of the issues of corporate governance and management style that may need attention if new investors are to be brought into the business.

The private equity house will almost certainly expect to nominate a representative to serve on your board. You may find this uncomfortable at first – especially if you are not used to being questioned and challenged

at board meetings – but the long-term effect on your business is likely to be beneficial.

It is normal to give warranties and indemnities so you will want to ensure that any potential negative issues are in the open. Unpleasant surprises that emerge when the transaction process is underway, typically during the investor due diligence, are bad news for everyone. You should stress to your management the importance of full disclosure of all material, or potentially material, issues to you.

The private equity deal will probably have a profound impact on your business, and you will impress if you demonstrate that you have considered the implications fully and are ready to implement the necessary organisational and cultural changes.

The importance of timing

Internal factors

Consider the timing of the deal carefully. Internal factors such as new management settling in and the trading position of your company, are important.

Current year earnings will have a major effect on the quality of the deal and you will want to be able to demonstrate an ability to meet or beat your budget.

The deal process might take three to six months. To focus investors on pricing the deal based on current year numbers you should usually aim to complete in the second half of your financial year.

External factors

External factors, such as economic conditions, levels of overall demand in your sector, and the mood of the financial markets will also have a bearing on the timing of the decision, though these are likely to be of secondary importance. If you can see the way the market for your product or service is moving, and you can show how your business will benefit, you will have a clear advantage. Although in a perfect world you will be approaching private equity houses when your particular type of business or sector is 'flavour of the month', delay may not be the best policy –

procrastination gives a negative impression and is seldom the mark of a successful entrepreneur.

There is merit in setting an optimum target month for completion of the transaction and working backwards, defining realistic target dates for the various components such as preparing the business plan, agreeing the deal and completing the due diligence process.

Grooming the business

If you have the time before the deal process gets underway, start to implement the key improvements you think need to be made to the business to increase its attractiveness to investors. By taking steps to remedy weaknesses, you will have demonstrated to private equity houses that you understand investors' requirements.

Accounting policies

Private companies often have tax-driven policies which tend to understate profits, whereas quoted companies usually have earnings-driven policies which result in a more positive interpretation. Even if you prefer not to change a prudent accounting treatment, recalculating the numbers could be an instructive exercise which helps you to enhance the valuation of your business.

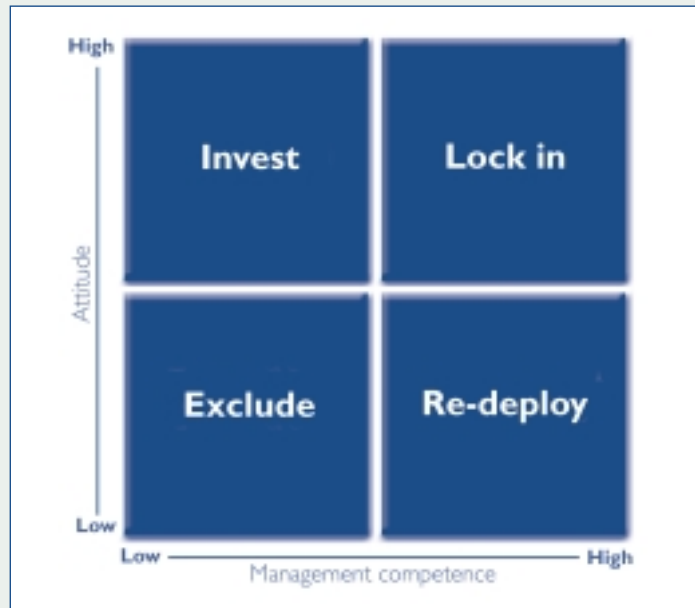
Management team

Your management team may require attention. Take steps to fill any gaps and plan for an effective incentive scheme that locks in the key people who can add value to the business.

People issues

Dealing with people issues is often the most challenging aspect of the private equity process. Strengthening the team usually carries a personal cost: it may even be necessary to bring new people in over the heads of senior staff. The financial team is particularly critical as it must be capable of delivering timely, quality information to impress investors and their advisers.

Strengthening the management team



Be ready to take some tough staffing decisions. Lock in or nurture people who have the right attitude; redeploy or exclude those who do not.

The only solution is to put personal feelings aside and to assess the key individuals dispassionately in terms of their attitudes and competencies. Those who have what it takes must be locked in as part of the core team, while those who lack competence can be trained. Tomorrow's management stars need to be nurtured. Provided they have the right attitude, they can be taught the skills – the investment you make in them will soon be repaid. Managers without the attitude or competence needed to deliver growth may need to be moved into new positions to re-motivate them, or if need be, excluded altogether.

The business plan

The business plan is a key document in most private equity transactions. It is the basis on which private equity houses, banks and any other participants will assess your business and make an initial decision on whether to offer you financial backing. It must contain the rationale for the deal and an explanation of where the business is going and how it is going to get there.

The business plan should be a selling document, concise and punchy in style. It must be capable of attracting the attention of private equity houses who see – and reject – many such documents. But it must also be truthful, accurate and thorough. Statements that are misleading or incomplete could damage your credibility and create problems in the future.

The financial information you provide in the plan will be studied closely, so take great care to ensure that it is robust and comprehensive. Taking early advice on the presentation of the written and financial information is critical.

You should include both historic information, such as profit and loss accounts, balance sheets, cash flows and forward projections to demonstrate how your strategy will translate into improved earnings. Identify any non-recurring expenditure clearly, so that readers can focus on the underlying earnings pattern.

Management must have full confidence in the plan. They will have to live with it, and with the financial structure developed around it, for several years. Although your financial adviser will be able to guide you on content and style, the document should be owned by you or the management team and reflect your style. Allow several weeks for the drafting process and continue working on the text until you are all entirely satisfied.

Structuring the business plan

Your business plan should contain the following elements:

- **Executive summary** – This should be hard-hitting and positive in tone: unless you engage your readers here they may not bother with the rest of the document. Include all the key points about the business, refer to the amount of funding required, explain how the company will use the funds, and mention the exit strategy.
- **History, business and products** – This should be a factual description of the company covering its products, customers, supplier relationships, premises, and how the company has developed.
- **Market and competition** – This should be a well-argued analysis of the market in which you operate, so that readers understand its overall size, your company's share, your competitors, trends and any other relevant information.
- **Strategy and business development** – It is vital to get this section right, as it must convince readers that you have a credible strategy for growth. It should explain the targets you are setting, the new markets or products you intend to develop, and the expansion or acquisition plans.
- **Management and organisation** – Explanation as to how you will implement the strategy is required here. The section should include descriptions of the management team, the company structure, management succession and human resources policy.
- **Summary financials** – Historic financial summaries should be provided for the past three years. Future projections need to include summary integrated profit and loss accounts, balance sheets and cash flows. The cash requirements need to be clearly understood.
- **Appendices** – For example, the most recent audited accounts, the detailed financial projections, CVs of the management team, an analysis of strengths, weaknesses, opportunities and threats (SWOT), press cuttings and company literature.

Managing the transaction

Decide at the outset how much you want to be involved in the deal-making process. If you do not have an active, hands-on role in the business, you may have more time available for project managing the deal. But ask yourself whether you have the appropriate mindset, knowledge and skills for this exacting task.

What to expect

There are several distinct stages in constructing a successful private equity deal. The sequence varies according to the nature of the transaction, but might comprise:

- selecting a financial adviser
- drafting the business plan
- structuring the deal
- holding initial meetings and obtaining indicative offers
- agreeing equity and loan terms
- preparing heads of agreement
- conducting due diligence
- finalising terms and conditions of the legal framework.

Private equity negotiations

You should prepare yourself for a series of negotiations covering various aspects of the transaction, such as valuation and the size and nature of the stakes held by the different parties. During the initial round of negotiations, it helps to have several institutions interested in your proposition. As in any deal, your negotiating position is strengthened if investors know they are in a competitive situation.

An important area of negotiation will be the structuring of the private equity house's shareholding. Economic and minority protection rights are also likely to be a key issue, depending on how the transaction has been structured.

Economic rights give the investing institution the assurance that they will receive a specified level of dividend or interest to safeguard their investment. Minority protection rights give far-reaching powers of investment protection – ultimately, in cases of financial default, the

institution may be able to take control over your board. However, it is rare that such a draconian power will ever be exercised – private equity houses usually avoid interfering in the running of a business unless very serious problems have arisen.

The private equity house

Although all private equity houses are looking to achieve a substantial return on their investment, there are differences between them in the way they seek to structure their deals. Some need to take a greater proportion of their return in the form of interest or a special dividend paid out before exit. If the company can afford it, providing a yield can help reduce the equity stake required and so maximises your potential upside. The challenge is to identify the right private equity house partner, whose approach fits with the needs and characteristics of your business.

Deal structure is important, but it is not the only issue – personalities matter too. The success of the deal may ultimately depend as much on the chemistry you have with your private equity partners as on the financial details. If you put your proposals to several institutions, you will get an opportunity to meet and assess the personalities involved – as well as generating interest and a competitive environment.

Your financial adviser

Selection of a private equity partner is one of the tasks your financial adviser will be able to assist you with. Your adviser plays a key role throughout the transaction, providing practical support and advising on key issues such as your business plan, evaluation of offers, deal structure and valuation as well as negotiation of the commercial terms.

The appointment of a financial adviser may well be the first action you take to initiate a private equity deal. Choose your financial adviser with care. Putting a private equity transaction in place is complex and time consuming: your adviser must be supportive and sympathetic to the particular needs of your business, as well as technically capable, well connected and a good negotiator.

Banking negotiations

Banks provide debt and working capital required to support the transaction and finance future growth. Debt terms will depend on the collateral available to the bank and the cash flows of the business.

Your financial adviser will help you select suitable banks. The private equity house may also be involved, as it has the key role in defining the transaction. Ideally, several banks will be invited to pitch, one of which will probably be your company's usual bankers.

The negotiations are likely to focus on the level of debt, interest levels, the repayment profile and the nature of the security.

Increasingly the leading banks have sought to offer alternatives to traditional private equity financed deals. It may be possible to structure a deal without a private equity house.

The legal work

The legal teams draw up the contracts and advise on any legal issues arising.

Several different legal firms may be involved, acting for the various parties such as the vendor, the private equity house, the bank and any other investors such as members of the management team. Lawyers will be extensively involved in the drafting of:

- heads of agreement
- the sale and purchase contract, if the transaction involves a change of ownership
- new articles of association for the company
- any shareholders' agreements
- banking and private equity financing agreements
- the directors' service contracts

As the owner you will need sound legal advice in order to take an informed view on key documents and deal with legal issues as they arise. The new investors will probably undertake legal due diligence. Legal diligence is used to establish your company's contractual position with employees,

customers and suppliers, and its title to assets. Lack of contracts and documentation is commonplace in entrepreneurially-run businesses, and you may wish to conduct your own review and resolve any grey areas before the transaction gets underway.

You may also be required to indemnify new owners or investors against contractual or title disputes arising after the transaction has been completed, and you will certainly be expected to warrant the information provided to new investors.

Additional services

The private equity house is likely to appoint a firm of professional investigating accountants to carry out financial due diligence. It will probably also appoint a consultancy to review the market in which your business operates and assess future prospects.

Other professional services may also be involved, such as property surveying where land or buildings are included in the transaction, and actuarial advice where pension fund valuations are required.

The provision of high quality, timely information is essential for a smooth transaction process. Problems obtaining information can be indicators of weak management or inadequate controls, and can result in lower values or even put the deal itself in jeopardy.

How much will it cost?

Costs vary widely according to the type of transaction, the nature of your business, and the complexity of the issues to be resolved.

As well as fees for corporate finance, accountancy and legal work, you may be asked to pay arrangement fees for private equity and bank finance. In addition, you might be required to underwrite other parties' costs should you decide to withdraw from the deal. These fees are usually treated as a cost of the transaction and borne by the company, not by you personally as the owner.

If the advisers are positive about your transaction and believe it has a good chance of success, they may be willing to work partially on a

contingent basis. Although their fees will be higher if the deal succeeds, you will not have to pick up the whole tab if it fails.

Taking the first steps

A private equity deal can be a transforming experience, for owners, management and the company.

Private equity could provide your company with a much-needed boost, setting it on a new path of growth. It can also be a means of realising value immediately, either by an outright sale signalling the end of your involvement in the business, or a sale of a stake enabling you to retain significant share in the future value.

Your first step may be to appoint a financial adviser who is close to the private equity marketplace and can give you an objective appraisal of the prospects. Once you have established a deal strategy, you can start to prepare the case you will put to private equity houses, perhaps by brainstorming the issues with your private equity and your most trusted colleagues. Use the following checklist to help ensure that you have considered the key questions:

- What is the company's value?
- What is the growth story?
- What are the issues facing the market?
- Can the management team deliver the growth, and are they adequately incentivised?
- Are there management weaknesses that can be resolved immediately? If not, what is the longer term strategy for strengthening the team and, is it critical to the deal?
- What is the company's debt capacity?
- Are the financing proposals adequate? Or is there a danger the company will need a further, unscheduled round of funding?
- How good are the current earnings figures? Can current strength be sustained over the medium term, or is it just a temporary blip?
- Is any bad news expected, such as a major sales contract falling through or a new competitive threat emerging?
- Are contracts or documentation in place covering key aspects of the business?
- How will investors realise their gains – and when?

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An A-Z of private equity

These are some of the private equity buzz words you may encounter.

Asset based lending

Lending linked to the value of assets covering land and buildings and current assets such as stock and debtors.

BIMBO

Buy-in management buy-out (management team consisting of existing management and outsiders).

BINGO

Buy-in growth opportunity (transaction in which the buy-in receives more funds than required to acquire the target business, which is used to fund a large and rapid expansion programme).

Capital structure

The way in which capital is deployed in a company, for example the ratio of debt to equity.

Caps and collars

Mechanism used to fix interest rates on loan agreements between agreed stated interest rates.

Captive fund

Private equity house which receives its finance from within the group to which it belongs. Contrast with independent fund.

Collateral

Security over a business' assets held by providers of debt finance.

Convertible preference shares

Preference shares in a company which carry rights to be converted into ordinary shares.

Cost of capital

The rate of interest a company pays for its capital.

Covenant

Terms and conditions of (usually) bank lending, which need to be met to avoid breaching loan agreements with banks.

Discounted cash flow

A method of measuring the returns from a project or investment that takes account of the cost of money over time.

Dividend coupon

Net rate of dividend expressed as a percentage of a share's nominal value.

Earn-out

Mechanism that links the price a vendor receives for the business to its future profitability, with deferred payments to the vendor on achievement of agreed profit targets.

EBIT

Earnings before interest and tax.

EBO

Employee buy-out.

Enterprise value

The value of a business if it was debt free and cash free. Deduct the net debt to calculate the equity value.

Equity

Ordinary shares entitling the holder to membership rights in the company.

Equity kickers

See Warrants.

Exit

The method in which a private equity house sells some or all of its holding to realise its investment.

Follow-on investment

Further investment by a private equity house in the same business.

Gearing

A description of the borrowings in a business, usually expressed as a ratio to equity or a percentage of shareholders' funds.

Goodwill

Any additional value a business may have beyond its net asset value.

IBO

Institutional buy-out.

Indebtedness

Amount of borrowings (including leasing) in a business.

Independent fund

Private equity house which invests funds raised separately from the group to which it belongs.

Initial public offering (IPO)

Raising capital by issuing loan stock or shares to the stock market for the first time, via a placing or an offer for sale. Also referred to as a new issue.

Internal rate of return (IRR)

The compound equivalent annual rate of return on an investment. An investment is only worth undertaking where the IRR exceeds the cost of capital.

Introduction

One way of obtaining a stock market listing. See also Placing.

Junior debt

Debt secured on a company's assets, ranking behind senior debt and mezzanine finance.

Lease-back

A way of obtaining finance by selling an asset to an institution and then leasing it back.

Leverage

Method of financing involving high amounts of debt and low amounts of equity to optimise returns to equity holders.

Loan stock

Loans made to businesses by financial institutions, with a schedule of payment and bearing interest.

MBI

Management buy-in.

MBO

Management buy-out.

MEBO

Management and employee buy-out.

Mezzanine finance

Debt secured on a company's assets, ranking ahead of junior debt but behind senior debt. Often has a warrant attached entitling mezzanine providers to a share of the company's equity.

New issue

See Initial public offering.

Options

The right to buy shares in a company at a specified price, commonly granted to senior managers to incentivise performance. See Warrants.

Ordinary shares

See Equity; contrast with preference shares.

Participating dividend

Dividend entitlements expressed as a percentage of profits after tax as opposed to a fixed dividend rate.

PBIT

Profit before interest and tax.

p/e ratio

Ratio of the profits of a business to the price paid. Usually based on profit after tax.

Placing

The sale of newly-issued shares to institutions, perhaps as part of a stock market listing. A placing is a potential exit point for private equity houses wishing to take profits.

Preference shares

Shares in a company which carry entitlement to a fixed or profit-related dividend and assets on a distribution ahead of ordinary shareholders. Generally redeemable.

Private equity

Finance available (usually from financial institutions) for investment in unquoted companies. Also referred to as Venture capital.

Ratchets

Mechanisms that adjust relative shareholdings based upon performance or on the achievement of specified milestones.

Refinancing

Replacement of one source of finance with another, for example one bank replaced by another lending on different terms.

Replacement capital

The sale of shares to an institutional investor to replace existing shareholders or reduce their stake. Often colloquially known as a money out deal.

Return on investment (ROI)

ROI and return on capital employed (ROCE) are ratios which show a company's profit as a percentage of assets (ROI) or capital (ROCE).

Seed capital

Capital used to fund initial feasibility of a product or business.

Semi-captive fund

Like a captive fund, but also manages funds raised independently of its parent group.

Stretched lending

Form of debt finance where repayments are loaded towards the end of the term of repayment.

Syndication

Arrangement between equity institutions to spread an investment between more than one private equity institution. Also applies to banks and lending. More common on larger transactions.

Turnaround

A loss-making or under-performing company which has been identified as a target with a strategy of reviving its fortunes.

Unsecured loan stock

Loan stock with no security over the assets of the business to which it advances its loan.

Venture capital

See private equity.

Venture capital trust

A trust managed by a private equity house which invests in smaller unquoted UK companies and offers tax advantages to investors.

VIMBO

Vendor-initiated management buy-out.

Warrants

Rights of conversion into a stated amount of the company's shares. Often attached to mezzanine finance. Also referred to as 'equity kickers'.

About BDO Stoy Hayward

BDO Stoy Hayward's dedicated Private Equity team specialises in advising managers and owners of entrepreneurial growing businesses. We apply our extensive practical experience of private equity transactions and thorough technical knowledge to help our clients maximise their opportunities.

We take the lead adviser's role, providing owners with specialist advice on options, strategy, valuation, sources of finance, negotiations and transaction structuring. Where required, we co-ordinate the entire deal process from inception through to completion.

BDO Stoy Hayward provide specialist advice to growing businesses. In the UK, we are the leading accounting organisation focusing on advising entrepreneurially owned businesses. Internationally, BDO is the world's fifth largest accounting organisation with partners and staff who specialise in advising growing businesses in over 90 countries.