Understanding Private Equity: Corporate Tips for 'Big' Business

By Investment guru, Len McDowall

This article takes a look at Private Equity Funds as a source of capital.

Private equity is capital provided by Private Equity funds (PE). They take an equity stake in your company. This can be via the sell down of your shares, or the issuing of fresh capital.

Private equity is usually at the bigger end of town, when your business is established, profitable, big and safe. Private equity funds are not risk takers and have access to large amounts of capital. Therefore they go for the big deals and sometimes take companies off the ASX. The funding is usually used to expand, pay out the original owner, make acquisitions or fund organic growth into new markets.

Private equity investors also like to provide strategic operational and financial advice and therefore usually require a board seat, if not majority control of the company. They make their money by buying a company at reasonable multiples, say 4 times profit, then building the profit over 3 to 5 years. They then exit via an IPO at say 10 times the profit. Or they could sell to another private equity fund, or to another company – sometimes this is a competitor.

Private equity has somewhat of a bad name in the business community. This is probably due to the experience of some business owners who have lost their company to a private equity firm. This can happen because PE investors have strict terms that come with their money – many linked to performance. So if you don't perform to what has been agreed to upfront, the terms allow the investor to increase their shareholding. In the worst case scenario, the original owner may lose their company completely. These are called **'rachet clauses'**. This area can get very complicated and it's best to have a good experienced lawyer on your side when negotiating these deals.

Private Equity investors receive a slice of the company based on an agreed valuation. The investor is like a business partner, sharing the upside as well as the downside of the company. Because it is equity, there is no need to repay the funds, or make interest payments. There may be dividends in the case of profits, but this is all agreed upon prior to them coming onboard.

PE funds can also do what is called a **Management Buyout**. This is where the management is funding into the business and usually the founder is taken out. The new management is given equity, performance bonuses and/or options in the company.

Private equity firms are basically clever fund managers who invest capital on behalf of institutional clients such as superannuation funds, large insurance companies and sometimes high net worth investors. They offer their investors a higher return – usually around 25% pa to reflect the slightly higher risk of this asset class. A Private Equity firm's return on their investment is dependent upon your business growth. This means they are as motivated as you are to grow your business and build its market value.

If you get to the point where a Private Equity firm is keen on sending some money your way, you will get to what is called a **Term Sheet**. This is like a heads of agreement setting out what the deal is going to be. Once this is signed off by both parties, Due Diligence commences. The term sheet will be subject to satisfactory completion of Due Diligence.

Due Diligence is where the investor checks out everything you have presented to them. Their lawyers and accountants do this for them. This is a lengthy, detailed and sometimes painful process that may take up to 3 months.

Once they are happy that the information provided is correct, the funding happens.

Why use private equity? There are many reasons. Firstly, there may be significant market opportunities for your company both here and abroad but you lack the cash to pursue them. Maybe you are growing too quickly and need funding to scale up and open new premises.

So if you are a well established company, with solid and consistent cashflows, growing profits, in a stable industry, with good management and you are looking for a big bag of cash ($5m +) then a private equity fund may be for you.

If you are a start up, early stage or fast growing business with lots of blue sky ahead, then you'd be wasting your time approaching Private Equity funds in Australia.

At the end of the day, you have to be willing to trade a share of your business in order to own a smaller stake in a potentially much larger business. 10% of something is better than 100% of nothing. This is the mindset you must employ.

A list of Private Equity funds can be found at via the Australian Venture Capital and Private Equity association. Go to www.avcal.com.au for more info.

About Len McDowall - Managing Director, Integral Capital Group Pty Ltd

Len McDowall was previously inaugural Chairman and Managing Partner of Bird Cameron, Chartered Accountants, (now know as RMS Bird Cameron) which employed 1000 people in 50 offices in Australia and Hong Kong. Len established Bird Cameron's mergers and acquisitions division in 1987.

Len has extensive experience in all facets of financial management with a particular emphasis on structuring and negotiating joint ventures and capital raisings. Following his retirement from the accounting profession Len and his partners established the Integral Capital Group. Len specialises in mergers and acquisitions, public floatation's, the creation of financial management strategies and capital management, and has successfully completed hundreds of transactions in these fields. Len McDowall founded Integral Capital Group in 1990.