CORPORATE
FINANCE

PKF FRANCISCLARK
Chartered accountants & business advisers

EQUITY FINANCE

A practical guide for entrepreneurs, directors, managers and shareholders

Supporting you and your business

Equity Finance

A practical guide for entrepreneurs, directors and shareholders of private businesses

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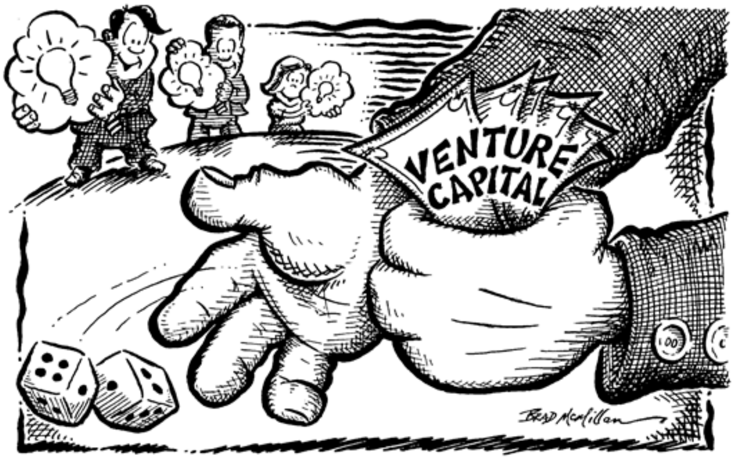
1 Introduction

Background

"Venture Capital" ... *"Private Equity"* ... *"Business Angels"* ... all terms that evoke images of large sums of money being made and lost in high risk business gambles.



But what do these terms actually mean, and how can they be of use to your businesses? Is it for you? How do you access it? This booklet intends to answer these questions and provide an initial guide to assess whether it is suitable for you. In the rest of this section, we provide an introduction to the equity marketplace.

What is equity finance or venture capital?

Equity finance refers to funding obtained in return for issuing shares in your company. Therefore, the equity provider shares in the long term success of your business, although this does not mean that they are not interested in receiving money in the short term.

The backer is far more interested in the potential of the underlying business rather than whether you have any security for the money to be raised. This changes the whole process of finance raising, making it entirely different from simply approaching your bank manager for a loan or an overdraft.

Types of equity provider

In general, equity comes from three distinct sources:

- Private individuals, known as Business Angels;
- Private institutions, known as Venture Capital or Private Equity; or
- Public markets, such as the London Stock Exchange, AIM, Plus-SX and Sharemark.

This guide concentrates on private sources, with a focus on institutional equity. The difference between Venture Capital and Private Equity is indistinct. In general, Venture Capitalists invest in minority stakes in early stage businesses, whilst Private Equity Houses invest larger sums in more developed companies. For the majority of this guide we refer to both as equity providers ("equity provider").

There is also a recent innovation in the provision of equity (and debt) funding of "crowd funding", where investors (usually individuals) and businesses seeking funds are matched through an internet site. This is still in early stages in the UK, but is being actively encouraged in the US, although it remains a controversial topic due to the high risks of this nature of investment.

Whose money is it anyway?

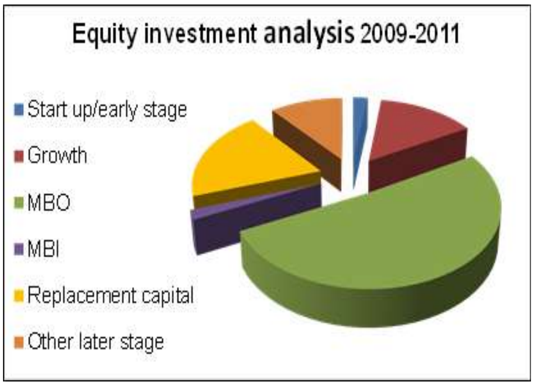
It is critical when dealing with an equity provider to understand who their actual customers are. Whilst Business Angels tend to invest their own money, the equity provider invests funds entrusted to it by a collection of financial backers. These financial backers invest their money in expectation of a financial return over a period of time, and it is to these backers that the equity provider owes their main allegiance. Therefore any business seeking money should not view themselves as a client of the equity provider – they have to view themselves as persuading the equity provider to invest other people's money into them. This helps to explain the authorisation process and checks what the equity provider has to go through to make an investment.

Uses of equity finance

Equity funding can be useful for all stages of a business' lifecycle:

- **Start up or seed corn** – Funds provided to companies that have only been in existence for a short period of time, and may have not yet commenced selling products or services. The closer the company is to making a sale, the easier the funding process. Specific technology sectors are also easier to fund, such as Renewables.
- **Growth** – Funds provided to expand current internal facilities (production, working capital, etc) or invest in marketing to expand customer base. Often used for acquisitions as this provides a track record for the financial backer to assess.
- **Management Buy Out ("MBO")** – Funds to allow the business to be bought by the internal management team. The funds can also be for a Management Buy In ("MBI"), where the management team buying the business is external and does not currently work for the business (although these are very rare in today's climate given the poor track record of return on these types of deals). Alternatively, it can be via a combination of external and internal management merging into one unit to buy the business (known as a "BIMBO" for Buy In Management Buy Out!).
- **Exit** – Funds to allow one of the current owners to exit, often used to solve succession issues. The equity provider takes the place of the current owner allowing the business to continue uninterrupted or not weakened by having to fund the exit from its own cash resources.
- **Rescue** – Funds provided to allow a company to trade out of financial difficulties.

In terms of ratios between the above categories, the opposite graph shows the current preferences in terms of overall equity provider investment in the UK (source BVCA).



Individual backers may be more focused on one stage, and certainly MBOs are usually more popular than start ups or rescues, due to their historic record in producing good returns for financial backers. Knowing the key interest of a particular source is crucial in gaining the right backer (or any backer at all) for the project.

Smaller equity deals

Smaller equity deals (sub £2m equity) present a very specific problem for institutional investors. The amount of work that has to be undertaken in an equity deal does not directly relate to the size of the deal. Equity investment tends to require extensive due diligence investigations into the company and its marketplace, considerable legal documentation, etc. Much of this process is similar even if the company is smaller, and some can even take longer where there are less management resources to devote to helping out in due diligence, etc.

However, the return for equity investment usually revolves around a percentage of the original investment, i.e. the smaller the investment the smaller the absolute return. Therefore, smaller deals can encounter similar costs but smaller rewards.

It is of little surprise that many equity providers have consistently moved their minimum investment upwards. Fortunately the last few years has seen a number of new equity providers in the market that specialise in smaller deals, and we have good relationships with many of them.

Confidentiality

Confidentiality is a major concern when seeking equity finance, especially to fund the exploitations of new inventions or where the transaction is unknown to the employees, such as an MBO. We have never encountered problems in confidentiality with equity providers – it is definitely not in their interest to be known for not appreciating the confidentiality of projects on which they are consulted. If confidentiality remains a concern, then we have a standard template confidentiality letter, or you can download a pro forma template from the BVCA website (www.bvca.co.uk).

Business Angels are usually also circumspect, but as you are dealing with individuals, it is always better to put a confidentiality agreement in place, if only to emphasise that you are taking confidentiality seriously and expect the same from them.

The only exception to the above is when dealing with intellectual property, where patents or other legal documentation may require you to obtain confidentiality agreements before releasing details of the product/service planned.

Sources of equity finance

There are a large number of sources for Venture Capital, and most are members of the British Venture Capital Association ("BVCA"). There are also a number of websites providing directories of each equity provider stating their general preferences.

Business Angels can prove harder to track down. Whilst there are a number of networks, many charge an upfront fee for assessment. Furthermore, most individuals are only interested in investing in companies in their local area. PKF Francis Clark does have contacts amongst these networks and also direct contact with numerous potential Business Angels. Our Corporate Finance team can advise further in this area.

PKF Francis Clark

In dealing with equity providers, be they institutions or individuals, you need good, experienced advisors at your side. The Corporate Finance team at PKF Francis Clark is one of the most experienced equity finance teams in the region. We have dealt with local and national providers of this type of finance on many occasions and can guide you to a satisfactory conclusion.

For further information, speak to Andrew Killick and Paul Crocker - our Corporate Finance partners, or your usual PKF Francis Clark contact, or visit www.pkf-francisclark.co.uk/dealmakers,

Other guides

This guide is intended to be used in conjunction with our other guides to Effective Business Planning and Management Buy Outs. It does not generally repeat the subject matter covered in those publications, but does summarise some of the main issues.

2 Myths and misconceptions

Introduction

It is fair to say that the equity industry, especially Venture Capital, is not viewed in a favourable light by many individuals. Some of this is based on reality (although much is outdated), whilst some is based on a lack of knowledge.

To start our guide, in this section we try to correct some of the common misconceptions and myths about equity.

The *"Vulture Capitalist"* and the *"Viet Cong"*

Terms such as Vulture Capital and Viet Cong have been regularly used as derogative descriptions of Venture Capitalists. The imputed worst characteristics revolve around them being greedy individuals and organisations trying to make money out of other peoples' hard work and ideas.

"My error, sir. On the phone I thought you said 'venture' capitalist."

Whilst extreme and overly harsh, this description does highlight one important fact – the equity provider is generally only interested in making money. Very broadly, they will try to design the deal to make a return of 3 to 5 times their investment over three to five years, with most of this from the eventual sale of their shares (as explained in more detail in Section 6).

Business Angels may take a slightly different role and want to be more involved in the business itself, but are still motivated by the potential sale, and uplift in value, of their investment in the business. Due to the higher risk in some Business Angel deals, they may require a significantly higher return than an institution.

Recognising this fact – the concentration on money and reward – allows you to place equity providers into context. They are simply selling money – expensive money, but still just money.

However, the relationship with the equity provider is likely to be for the medium to long term. Therefore you should be careful during negotiations not to leave the equity provider feeling as though they have been bled dry (and, of course, vice versa), as this will make future relations more difficult. A good deal is generally a good deal for both sides!

"Equity money is risk money"

Whilst it is true that equity is at the opposite end of the risk/reward spectrum to bank borrowings (bank debt being low risk/reward and equity funds being high risk/reward), this does not mean that equity providers accept risk as a given. This is even more true in the current climate, where many equity providers have become more risk adverse.

They will expect you (and your management team) to address the main risks of the business in a business plan and explain how you will minimise the consequences.

"They want control of my business"

One of the most common myths, and a result of the fact that the equity provider actually receives shares in your company, is that they want to run your business.

As highlighted above, the equity provider is mainly interested in making money. They may become very familiar with the businesses they invest in, and the markets within which these businesses operate, as well as introducing external industry experts to help the business grow. However, they will rarely pretend to be experts in running any individual business.

Whilst the legal documents may occasionally include the ability for the equity provider to take control, known as swamping rights (see Section 8), this is included as a definite last resort.

Business Angels approach the situation differently, but again seeking control is rarely in their interest of allowing you to make money for (or with?) them.

"Raising equity finance is easy - All we need to do is write a good business plan"

"And whenever we need more VC funding, we double click this icon."

As you will appreciate from this guide, raising equity finance is not easy. It is a time consuming and exhausting process, which can prove a severe distraction from the running of the business. The best defence for this is to be prepared by researching the issue thoroughly (starting with reading all of this guide), and making sure that there is a valid underlying reason for the need for equity finance. Whenever things get tough, return to this valid reason and check your logic.

“They are only interested in exiting via a sale”

Exit for an equity investor can be by way of trade sale of the entire business, but could be by a sale via an MBO to a second tier of management (potentially supported by another equity player), a flotation of part or all of the business (although much rarer) or even by a debt refinancing exercise.

This last option is especially flexible in that the business raises a further round of debt finance to buy out the shares of the original equity provider, thereby allowing the maximum flexibility to the remaining shareholders. However, due to the relationship between profits, valuation of the business and the amount of debt potentially available to the business, it is only usually feasible in one stage if the equity providers to be bought out own less than say 15% to 20% of the company.

3 Turn-ons and turn-offs

Introduction

So what types of businesses are attractive to equity providers? There are a number of specific characteristics that are often quoted by them as being either critical or important to their potential investment. There is an equal list of features that are viewed as danger signs, some serious, some less so.

Characteristics for successful funding

1. **Strong management team/entrepreneur** – It is an old (but true) saying that a good management team can grow a bad business whilst a bad management team can wreck a good business. The quality of the team/individual is therefore critical.

   A critical issue with SMEs is the lack of a full **board of directors**. Whilst larger equity deals involve a Managing Director, Marketing Director, Financial Director, etc, the majority of SMEs rely on a smaller team of key individuals. This need not be a bar to raising equity finance, but does mean that the key individuals are even more important to the assessment by the equity provider.

2. **Exit route** – The majority of the return for the equity provider usually comes from the final sale of their shares – therefore there must be a clear method to achieve this exit. Without a clear exit path, most equity providers are unlikely to invest.

3. **Competitive advantage** – The funder will want to understand how you are going to make an increasing profit in the marketplace, which generally relies on the business's competitive advantage.

4. **Managed risk** – What are the risks within your proposal (and there will be some) and what is your strategy for reducing these risk levels.

5. **Adequate return** – This is generally, although not always, driven by growth in the profits of the business, itself generally driven through growth in sales. This underlying increase in value of the business is then increased by financial engineering techniques discussed further in Section 6.

6. **Realism** – There was a study done many years ago showing that the chances of a successful outcome from an investment were directly, and positively, related to the size of the trading loss forecast by the management in their first year. This reflects that management who can anticipate problems are better placed to cope with the problems that always arise in business life.

7. **Clear commitment** – How committed to enacting the business' strategy is the management team, financially (see below) and personally?

8. **Financial Commitment** – The size of the financial input from the management team or entrepreneur can be quite modest in relation to the sum invested by the equity provider. However, it should be seen as material to the individual involved. For larger deals, the rule of thumb used is one to two years' salary. For smaller deals, there are no real guidelines other than the word "material".

Danger signs

There are several common characteristics that will immediately have the equity provider "running for the hills":

1. **Claiming that you only need to take 1% or 5% of the total market** – A classic sales pitch that omits the fact that this means there are many other competitors in the market, generally larger and better funded than you. Whilst 1% may sound small, it generally translates into a large absolute

number– how is a small growing business actually going to persuade this many people to buy their product or service? Equity providers far prefer a business that intends to carve out a niche in a market and then become the dominant player in that niche

2. **Our projections are conservative/prudent"** – A variation on this phrase is in nearly every business plan sent to equity providers. By nature, the entrepreneurs that are looking to grow their businesses rapidly are optimists. There is always an awkward balance between presenting figures that:
   a. show a good enough growth in profits to attract an equity provider and support a high valuation that minimises the amount of equity to be sold to the equity providers; and
   b. can be justified to a due diligence team.
3. **"We have the first mover advantage"** – Being the first to produce a service or product is rarely enough. It is the first to be able to produce the service or product on a scale that is important. The businesses who are currently in the market will also want to defend their market position, to say the least. It is also usually the case that there are a large number of similar businesses out there which also think they will be the first mover – make sure you research the potential competition carefully as the equity provider certainly will!
4. **"The main potential competition is too large to be able to respond quickly"** – Whilst potentially true, it is usually wrong. When the competition sees profits being made, they will use their market muscle, in terms of distribution channels, client relationships or simply money to defend their market, and it is far too easy to copy most business models.
5. **Broad brush general positive statements** – You should avoid simple padding, which is difficult to justify. This can distract from the main message.
6. **Detailed history section in the main business plan** – The fact that the company has been in existence for many decades may be a good sign, but the equity provider does not need to know the name of every Managing Director since 1850. Relegate all such detail to the Appendices or remove it all together.
7. **Full and overly detailed CV's for every member of the management team** – There is no need to include details of every role of every job they have undertaken, such as gap year part time jobs. The equity provider simply needs to understand the flavour of the career path of the individual and the most relevant skills and experience – they also need to ensure there are no gaps in the CV hiding embarrassing facts that may make the investment less attractive, and more risky, for potential equity providers.
8. **Detailed funding terms** – Avoid setting out in the business plan your exact proposed terms of the equity investment, share percentages to be sold, repayment terms, etc. Whilst a general indication of the value of the business is needed, the detailed terms will be discussed at an early meeting.

Finally, there are several fabled features of a business plan that are said to be highly related to the potential failure of the business including winning the Queen's Award for Exporting and flagpoles or fountains in the car park. There are no scientific studies supporting these, but be ready for the joke if you fall into this category.

4 Advisers

Corporate Finance advisers

Corporate Finance ("CF") advisers (or "lead advisers"), such as the CF team at PKF Francis Clark, help manage the investment process from start to finish. If the equity finance is being used as part of a larger deal, such as an MBO, they will manage the equity raising as a part of the overall deal process.

The overall equity or deal process can be highly distracting for any management team, and the involvement of an experienced CF team can minimise the disruptive effect of the process on the business.

You should involve us as early as possible and we are willing to work, without commitment, on an assignment we believe has potential to try to agree a deal, and then to work on a partly contingent basis thereafter, again for the right deal. In this area we are making the same sort of risk/reward judgements as the equity provider.

"I'd like to introduce the advisor who convinced us to invest in all those dot coms."

Early involvement of the CF team will allow the best presentation of the business case to the correct equity providers, and the equity provider will look more carefully at plans introduced through a respected equity team. We will coordinate all the other professionals and funders involved in the process, chasing everyone (including you) to meet the deadlines.

Needless to say, experienced CF teams should prove excellent negotiators with both the funders and, if relevant, the vendors of the business to be acquired. This will not just be limited to price, but also deal structure, business valuation, payment terms, etc. Finally, they can keep a sense of perspective in the deal – it is a means to an end, not the end itself.

Legal representation

As you will see in Section 8, there are many complex legal agreements involved in the equity process, making experienced lawyers critical to success. We stress the word experienced here, as the management team will need a lot of help to both understand the legalities involved and also appreciate what is fair to protect the equity investor and what is "over the top".

5 Process

Introduction

So, you now believe that your business may be suitable for this type of funding, how do you obtain it?

Obviously, the process depends heavily on the purpose for the equity finance. For an MBO, for example, raising the equity finance is only part of the overall puzzle, albeit a major part. However, in most deals, the raising of the equity finance is the part that takes the most time, and you should allow three to six months from start to receipt of the funds. At PKF Francis Clark, we have undertaken the process in five weeks, but this was the exception to the rule.

This section describes the more formal process when dealing with an equity provider. The Business Angels process varies from individual to individual but should generally follow the pattern described below.

We start by setting out overleaf a summary of the process, adapted from the BVCA guide in this area.

Stage	Your Responsibilities	Joint actions	Equity provider's responsibilities	Documents
Preparation ⇣	Investment readiness Appoint advisers			Advisers'
Approach to equity provider ⇣	Prepare business plan		Review business plan	Business plan
Initial enquiries and negotiations ⇣	Provide additional information	Meet to discuss business plan Build relationship Negotiate outline terms	Conduct initial enquiries Value the business Consider finance structure	Term sheet
Due diligence ⇣		Liaise with accounts and other experts	Initiate external due diligence	Accountants and other due diligence reports
Final negotiation andcompletion ⇣	Disclose all relevant business information		Draw up completion documentation	Disclosure letter Investment and share-holders' agreements Memorandum and Articles of Association
Monitoring ⇣	Provide regular accounts	Communicate regularly	Seat on board Monitor investments Constructive input Involvement in major decisions	Management accounts Board meeting minutes
Exit				

Investment readiness

We include below a list of key questions that the management team must have addressed before they start talking to equity providers:

- What are the main strengths and weaknesses of the management team and the business?
- What are the main issues affecting their market
- How much money will be needed in total to achieve the objectives, allowing for appropriate headroom?
- What is the value of the business?
- What exit routes are available?
- Why you are going for equity finance rather than all debt, grants etc?
- How reliable is the recent historic performance in predicting future performance?

Business plan

A good plan is vital to the process of raising equity finance. We have a separate guide to Effective Business Planning that covers the subject in some detail. We make the following comments about tailoring a business plan to the specific subject of raising equity finance:

1. **The presentation of the plan is still important** – Equity funders receive many hundreds or thousands of plans. You want your plan to stand out and good presentation is the starting point. Avoiding silly spelling and grammatical errors is just plain common sense.
2. **Use of intermediaries** – One of the main uses of a good CF team is that it is more likely that you will get the plan (or the executive summary) at least read by the equity provider. Plans received through intermediaries are usually taken more seriously as the management team are assumed to have proven they are serious by spending money on a third party professional and have shown themselves willing to take proper advice.
3. **The executive summary is crucial** – Building on point 2, this may be the only bit that the equity provider will read, and they certainly will not go any further if they are not convinced by this. This must take the reader by the hand and build a case that convinces them the business has a good chance of future growth and profitability. Obviously, this is slightly harder for start up businesses.

Initial approach

Equity providers tend to specialise in size of deals, sectors, geographic regions, stage of life-cycle, etc. Business Angels similarly tend to look for deals in industries they understand. As such, sending your plan to every equity provider is therefore unlikely to improve your chances, but simply depress you with an ever increasing number of rejections. Again use of experienced intermediaries here will ensure you are targeting the proposal at the right potential providers.

Speaking in person to the equity provider is always a good idea. You are going to enter into a long term relationship and the earlier you can build a rapport (or establish that you are not going to be able to build one), the better. A telephone call will also enable you to tailor the executive summary or covering letter to their specific requirements or objections raised in that first conversation.

Meetings

The entrepreneur or management team's first meeting with the equity provider is key in their assessment of the management team and their abilities. Whilst they may be unfamiliar with the equity process, they must be fully knowledgeable (and demonstrably so) about their business and its prospects, including a realistic assessment of the risks and weaknesses. The only detailed discussion regarding the investment that is needed at this stage is the amount of money needed, and perhaps a first feel for the valuation of the business.

The second meeting is a much different affair and has often been likened to a friendly interrogation. At this stage, the equity provider should now be fully familiar with the business, having reviewed the business plan in detail and undertaken their own research. This is where the tough questions will be asked and the valuation of the business becomes a topic of interest for all concerned.

Term sheet

After reviewing the business plan and meeting with the management team, the equity provider will issue a formal term sheet. This should cover the following:

- Amount to be invested
- Ordinary shares to be issued in return (showing the percentage of the business to be owned by the equity provider)
- Other shares/loans to be invested by the equity provider, and dividend/interest cost and redemption rights
- Due diligence requirements
- Costs
- Likely timescales
- Rights to appoint representative directors

The above terms are expanded upon in following sections in this guide. A Business Angel's investment terms will invariably be less formal but need to cover all of the above main areas.

Due diligence

After a discussion and agreement (usually after refinement if needed) of the terms, the equity provider will undertake a detailed financial, commercial and legal investigation of the business known as due diligence. This is usually a combination of their own internal resources, a third party accountant and, if needed, external expertise into the scientific or other expert aspects of the business. This can be a time consuming process, and it is at this stage that the business must reassess the need for confidentiality, as there will be visits to the business by unfamiliar professionals that may alert the employees that something is happening.

In addition, it is critical for the business' performance to continue to (or exceed) budget during this phase to avoid any renegotiation.

Legals

At the same time as the due diligence is being undertaken (or afterwards if there are any doubts about the due diligence process), the legal paperwork will be compiled and reviewed by lawyers on all sides (the equity provider will use their own lawyer). This is rarely an enjoyable process, but it is vital to ensure that everyone understands what they are agreeing to and what happens if something goes wrong. Pick good experienced lawyers and you will survive the process.

Final negotiations

During the final days before legal completion (and receiving the money), there are always final matters that come out of the legal paperwork or the due diligence. These often cause a series of renegotiations over the deal, amending minor and major terms. At this stage, the team must always remain calm and be willing to trade. What seems like life or death during this process can often seem trivial in hindsight.

However, this is subject to one vital final overriding comment. Before the deal is signed (and this applies to any deal, not just raising equity finance) you should pause and reassess the deal. Why did you undertake the deal in the first place? Does the current deal still achieve the same end result? Or has this been lost during the negotiations? A good adviser will always ensure that this final assessment is made and if necessary advise you to step away from a bad deal.

Completion

The completion meeting can be a bit of an anti-climax. It consists of a series of quite boring interludes interspersed by short bursts of frantic document signing. Eventually the money is transferred between banks electronically and everyone shares a bottle of champagne (or at least they do in our deals).

Start of the hard work

Once the money is raised, the advisers heave a sigh of relief and the real hard work starts for you. You must now produce the results promised in the business plan.

Monitoring

If everything goes to plan, over the next few years, the equity providers or their representative will attend monthly board meetings and review monthly management accounts.

As with so many things, plans rarely convert into reality. This is where a good relationship with the equity provider is essential and the surrender of a potential advantage during the negotiations process to keep the provider "sweet" may provide dividends.

It is also where the fact that the equity provider requires the business to grow and thrive to make its return, means that they will support the business through thick and thin, even advancing more money if things are going poorly (or well).

"I think you'll be pleased to see how low we've kept our costs."

Exit

After a few years of "happy marriage", it comes time for the equity provider to exit. As discussed previously, this may mean the sale of the business and the exit of all the shareholders, or the exit solely of the equity provider. At this time, another set of negotiations ensue, with you at least having some experience of the process.

6 Structure of the deal

Introduction

In this section, we explain how an equity deal may be structured. This generally revolves around obtaining a sufficiently high rate of return for the equity provider.

In general, equity providers make their money by investing in a company at an amount considerably less than they hope to sell their stake at a future date. Although they may receive other payments from the business, it is this final sale that generates their expected return. Take the following simple example where the equity provider invests £10m for a 20% stake in a company. The equity provider is paid dividends of say £400k per annum, and then sells his stake in five years' time for £40m.

The £400k dividends per annum generate an annual return of some 4% - slightly below their required annual rate! Taking into account the sale of their equity stake makes the calculations more complex, but increases their annual return to 34%, i.e. 30% of the return is generated by the final sale. In cash terms, the equity provider has received 4 x his initial investment. We will return to these calculations below in more detail.

The above figures demonstrate the importance of an exit. However, this is not to say that other aspects of the deal are ignored. On the contrary, there are many other methods to increase the equity provider's return or reduce their risk and many of these are common to most deals.

Share class

The first issue to appreciate is that the investment from the equity provider may come in two flavours:

- **Ordinary shares** – these carry full voting shares and entitlement to a share of the sale consideration of the company. Their value is intrinsically linked to the value and profitability of the business; and
- **Loan stock** – usually carrying a fixed interest rate and set repayment terms. This is in effect an unsecured loan.

In an equity deal, the majority of the equity may be invested in loan stock. This is important to understand, as this part of their investment is repayable, resulting in the equity provider owning the negotiated percentage of the business, but for only a fraction of their original investment – thereby boosting their rate of return.

Example of share classes on return rate

To review this effect, consider the following example whereby an equity provider negotiates an investment of £1m into a business in return for a 20% equity stake. This would seem to indicate an overall value for the business of some £5m. However, if only £100k of this investment is in ordinary shares, the equity provider will end up with 20% of the business at a net cost of only £100k (after the loan stock is repaid by the business). Whilst this may seem unfair, it highlights that the overall equity deal is not as simple as first thought.

Concentration on this aspect of the process misses the main requirements for the equity provider, which is the cash multiple returned or rate of return from the investment (Internal Rate of Return "IRR" – the equivalent annual percentage that the equity provider's money earns during the period of their investment).

To evaluate the effect of the above, consider the difference between these scenarios:

1. Invest £1m for 20% of a business, which itself is sold for £7.5m three years after investment. The equity provider gets £1.5m back for his 20% shares or a cash multiple of 1.5. The IRR from this investment would be 14% (trust us on this). Both of these are too low.
2. By translating £0.9m of the original investment into loan stock, which is repaid over the three years, the cash multiple becomes 2.4 and the IRR increases to 41%, making the deal potentially viable (assuming all other factors are right).

In any negotiations, the equity provider's return must be the main focus. Any alterations to the deal may have an effect on this rate, and this must be understood by the company and their advisers to properly negotiate any deal.

An important factor in increasing (or decreasing) equity IRR is the timing of the receipt of money. In the second example above, simply delaying the repayment of the loan stock until the end of three years decreases the IRR to 34%.

Other factors in the basic deal may include dividends on the ordinary shares and a premium on the redemption of the loan stock (say £1.25 repaid for each £1 lent).

Use of debt

Often equity will be part of a package or financial jigsaw. Equity is the most expensive form of finance and it is therefore important to view the overall financial package involving equity to understand exactly where it fits and how the returns can be shared between all funders and the management.

For a full worked example of a financing deal involving debt and equity, take an MBO where current profits are some £1m before taxation. A purchase price of £4m has been agreed and the total finance needed is as follows:

	£'000
Purchase Price	4,000
Costs	150
Working Capital	250
	4,400

The financial package for the deal might therefore be as follows:

	£'000
Management team input	150
Vendor deferred consideration	750
Invoice Discounting	450
Plant and machinery loan	300
Mortgage	450
Unsecured loan	1,000
Overdraft	300
	3,400
Missing finance	1,000
	4,400

The management team is happy with the consequences of raising equity and tries to agree a package with an equity provider.

The projections prepared by the management team show profits growing to a profitability in excess of £2m before taxation in five years' time.

The package agreed with the equity provider is as follows:

1. £100,000 into ordinary shares representing 20% of the company's shares, with rights to dividends equivalent to 30% of their share of profits after tax from year 3; and
2. £900,000 into loan stock carrying an interest rate of 9% and repayable in two instalments from year 3.

The above factors can be shown in an abbreviated cashflow for the business and the equity provider as follows:

£'000						**Year**
Business cashflow	**0**	**1**	**2**	**3**	**4**	**5**
Profits before interest and tax		1,000	1,200	1,440	1,728	2,074
Interest on bank borrowings		(138)	(112)	(61)	(50)	(48)
Interest on loan stock		0	(88)	(88)	(44)	0
Interest on deferred consideration		0	0	(41)	(29)	(16)
Taxation		(225)	(167)	(216)	(281)	(361)
Repayment of borrowings		(423)	(817)	(150)	(30)	(30)
Repay deferred consideration		0	0	(250)	(250)	(327)
Repay loan stock		0	0	(491)	(491)	0
Ordinary dividend to EP				(61)	(76)	(122)
Remaining cashflow		214	16	83	477	1,170
EP cashflow						
Investment	(1,000)					
Loan stock interest		0	88	88	44	0
Loan stock repayment		0	0	491	491	0
Ordinary dividend		0	0	61	76	122
Exit valuation						2,740
	(1,000)	0	88	639	611	2,862
EP IRR	**39%**					
EP Cash multiple	**4.2**					

The above could be an acceptable rate of return for an equity provider (again assuming a positive outcome on a plethora of other factors). However, you can now start to appreciate the number of factors that go into the above calculation. Simply accepting the 20% of shares going to the equity provider because it is close to their investment ratio (£1m equity input over a price of £4m) would be naive. It would also miss the fact that only £100k of the equity input is actually into ordinary shares.

Finally, the above emphasises how important the final sales value of the equity providers shares are in the level of the return. In the above calculation, the value of the equity provider's investment has gone from £1m to £2.7m, based on the increase in profits of the business. Without this increase in valuation, the cash multiple decreases to 2.4 and the IRR decreases to 24%.

7 Valuing the business

Introduction

Valuing a business is a very imprecise science (in that there are rules but they are usually vague and rely upon many subjective judgements) and this is particularly true when considering raising equity.

Basic valuation techniques

There are a number of ways to value a company, including (but not limited to):

- multiplying the underlying profits by a factor, known as the Price Earnings Ratio (PER) obtained from discounting plc ratios or from databases such as PERDa (a database PKF Francis Clark maintains);
- predicting the surplus cash that will be produced by the business over the next few years, building this into a suitable model (such as PKF Francis Clark's DCFC model) and discounting this back to arrive at a present value for the company;
- specific sector related valuation which may relate to turnover, net assets or customer numbers; or
- re-valuing all assets to present values (mainly used for property companies).

We use a combination of the above methods in our overall assessment of valuation.

Valuation and equity finance

Equity providers are generally investing for the long term of the business. As such, the current value of the business may not be a relevant factor. It may also be difficult to assess if the business is loss-making or just at the point of increasing turnover significantly.

Luckily, it is usually much easier to assess the valuation at the time of the equity funders planned exit, as the company is usually predicted to be highly profitable and growing. As such, it can be easier to value the business at that time and then work backwards.

As a last note on valuation, the management team/entrepreneur always tend to overestimate the current value of the business – as we have discussed previously, this can be irrelevant to the deal and should not be allowed to become a distraction.

8 Legal documents

The equity investment will usually be accompanied by the following legal documents:

1. Investment Agreement
2. Modified Articles and Memorandum of Association
3. Formal service contracts for key employees

Some of these will be in existence already and will be "tidied up" by the equity raising process.

The contents of the above obviously vary from business to business and deal to deal, but there are some common legal characteristics that are specific to equity finance that the management team need to be aware of:

Bad leaver/good leaver – As stated earlier, the equity providers are generally backing the entrepreneur or the management team. As such, they want the key shareholder/employees tied into the business as far as possible. This can be partly achieved by employee/director contracts, but one standard option is the inclusion of a punishment clause whereby the shareholder has to sell their shares if they leave employment. The value of the shares sold is defined so as to punish them if they leave within a certain span of time (two years after completion for instance) or if they are dismissed from the company for gross misconduct. As you can imagine there are a great variety of potential circumstances under which the shareholder could leave the company, which makes the situation awkward to draft and contentious to agree.

Swamping rights – There are occasionally defined circumstances whereby the equity provider gains voting control over the company. This does not alter their entitlement to dividends or the split of the consideration if the company is sold. It simply provides a level of protection for the equity providers so that in extreme circumstances they can force certain decisions to be made. As previously explained, these are very rarely used and usually prove highly contentious to agree.

BVCA member transfer – Some BVCA members try to insert the right to be able to sell their share-holding to another equity provider (usually defined as another BVCA member). This facilitates the sale of equity provider funds, but can undermine the relationship built up with a specific equity provider.

Performance criteria – Equity providers will often try to tie in the management team to their projections, by defining certain things (usually bad for the management team) that would happen if the projections are not met within a certain margin of error over a certain period of time. The negative consequences can vary from a simple penalty of dividends to potential loss of control through swamping rights.

Ratchets – Where there are differences between the management team and the equity provider, for instance in terms of the valuation of the company, then this difference can be bridged by the use of ratchets. This rewards the management team (usually through increased equity) if they meet or exceed budgets/projections.

Warranties and indemnities – The equity provider will want the management team/existing shareholders to provide certain guarantees to them over matters relating to the previous conduct of the company – for instance its recent financial performance is as provided to them, it is not currently being sued by customers/employees, etc.

9 Failure to raise finance

When things go wrong

As you will have gathered from the complicated equity raising process described previously, there is no such thing as a certain deal. Very few plans submitted to equity providers actually result in finance being raised. Many factors may result in a failure to raise the funds required:

Expectations too far apart – This mainly revolves around the valuation of the business and can be a major cause of deal failure. The management team must have a realistic view of the valuation of their business, but also acknowledge the wider deal and the requirements of the equity provider to earn a sufficiently high return.

Personalities – Sometimes the entrepreneur/management team just does not "hit it off" with the equity provider.

Due diligence – Issues can sometimes arise from due diligence that disrupt the process. Most of these can be avoided by a decent and honest business planning process and pre-reviews of audit files. However, sometimes issues (such as unapproved planning permission) cannot be spotted in advance.

Accidents and bad news – The equity process can always be disrupted if, for example, a major customer cancels a contract, or a main supplier goes out of business.

Some of the above factors cannot be predicted in advance, even with the best advice. Therefore, there must be a fall back plan, which can be:

Eliminate the problem – If the problem relates to a specific practical problem, say member of the management team, then this can be the time to take the tough decisions.

Business as usual – Continuing without an equity injection is always a possibility unless the business needs the funds to continue expanding, to improve (or reach) profitability.

Deferring opportunities – until funds can be accessed.

Reduce the funds required – and try again.

10 Key lessons - our advice

From the above, and our experience of the process, we would highlight the following as key lessons to be understood before undertaking the equity process:

- Be realistic (about valuation, risks, timeframe, business/ management weaknesses, etc).
- Start early, many months before you need the money.
- Prepare extensively for any meetings with equity providers. Never assume they know nothing about your business, market or industry.
- Ensure there is a level of personal chemistry between you and the equity providers. This will smooth the overall process and make future relationships much easier.
- Assume that the process will be harder, cost more and take longer than you expect.
- Appoint experienced advisers.
- Accept that business valuation may not be the key factor.
- Anticipate that something always goes wrong at the last minute (although usually not a deal breaker).

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