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INVESTMENT PARTNERS

A Guide to Private Equity

A guide to equity investment in private business

NZX Firm

INTRODUCTORY GUIDE

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What is Private Equity

Private equity is an investment class that encompasses all types of equity investment into private businesses. It also encompasses investments into public companies where the investment has the character of a private equity transaction.

Private equity can be broadly broken into the following categories: Venture Capital; Expansion Capital; Buy-Outs/Buy-Ins; and special situations such as Private Placements, Pre - IPO funding and PIPEs (Private Investment in Public Entities).

Venture Capital

Is often used to describe the private equity sector as a whole, but more accurately describes investments made in companies that are in an early stage of development (typically prior to the company generating profits).

Expansion Capital

Refers to transactions where private equity managers invest capital in an established company that will be used to fund growth opportunities or to expand the company's business into new markets.

Buy-Outs/Buy-Ins

Refers to transactions where private equity managers provide funds to enable current operating management to acquire an existing business (a management buy-out) or to enable an external manager or group of managers to buy into a company (a management buy-in).

Private Placements

In a private placement the private equity manager provides liquidity to existing shareholders through the purchase of existing shares.

Pre-IPO

In a Pre-IPO investment the private equity manager acquires a stake in the business prior to its initial public offer ("IPO") and then assists the company to prepare for its IPO and stock exchange listing.

PIPE ("Private Investment in a Public Entity")

Is a private equity investment in a company that is listed but possesses similar characteristics to that of a private company. In most cases its shares are seldom traded on the stockmarket, and the company is not widely followed by financial investors or analysts. As a result, the company does not have ready access to the capital markets to raise new funds.

Some private equity funds are focused on investing in one or two of the above categories, while other funds invest across the spectrum of private equity. These funds are commonly referred to as "generalists".

Why do Private Businesses Need Private Equity?

Although private equity transactions involving listed companies have been frequently reported in the media, public equity investments in private businesses are far more common. Owners of private businesses increasingly see private equity as an attractive source of expansion capital and management expertise. These resources are utilised to grow the business to a level where it will be suitable and ready for an IPO or trade sale (a sale to a competitor or industry new comer). In such cases, the private equity manager invests capital for a stake in the business and may also play a valuable role providing advice to the Board on issues concerning strategy and shareholder value.

Business owners who have built up a business over many years and are looking forward to retirement might consider selling part or all of the business to private equity managers. As part of an ownership succession plan, private equity managers enable the existing owner to realise value they hold in the business by acquiring a partial stake in the business or leading a full exit which usually involves assisting existing management to buy-out an existing owner.

What benefits do Private Equity Managers Provide?

In addition to providing a company with equity capital, private equity managers play an active role assisting the owners and management to grow the business in a manner that will create shareholder value over the long term. The foundation of private equity's ability to add value is an alignment of interests between the private equity manager as a shareholder and other shareholders (including management). Each has a genuine stake in the business and is firmly focused on growing the business.

Private equity managers have a medium to long term investment horizon for individual investments that averages around 3 - 5 years, but can last beyond ten years. Private equity managers focus on driving value within this timeframe by encouraging the adoption of a corporate strategy, investment in research and development, appointment of key people, optimising capital expenditure, and developing new products or markets.

The skills a private equity manager can provide include strategic and financial expertise, sector and/or country knowledge, merger and acquisition experience, corporate governance disciplines, assistance sourcing and structuring debt facilities, and other services specific to the private equity manager.

How do Private Equity Firms Generate Returns?

A private equity manager aims to generate returns for its investors through a combination of dividends, distributions, or capital returns from the sale of investee companies (commonly referred to as "exits").

A Boston Consulting Group study of private equity exits reported that almost half the value created by private equity managers was attributable to sales growth, while the remainder was attributable to an improvement in operating margins, exit multiples, or by the leverage effect.

The leverage effect or the use of debt to fund an investment opportunity is characteristic of many, but not all, private equity transactions. The purpose of the investment and the debt tolerance of the private equity manager will influence when and how much leverage is used in a transaction. Refer to the example on page 6 to see how debt may be used by an investment company to fund growth.

What are the Investment Timeframes for Private Equity Funds and Investors?

Private equity funds are usually formed with an investment horizon of 7 to 10 years. During the first few years, the private equity manager sources and analyses investment opportunities, and invests capital in private businesses when attractive investment opportunities are identified. Over time, as various investments are made, funds are called from investors until the committed capital is fully utilised.

Given that private equity managers generally hold an investment for 3 – 5 years on average, the private equity manager might receive dividends from investee companies, realise an investment, and make distributions to investors before the fund has invested all its committed capital.

The later years of the fund will be focused on the management of existing investee companies, including the opportunity for further investment or exit.

Private equity managers may set aside approximately 20 - 30% of the fund for subsequent investment in investee companies. This enables the private equity manager to help a portfolio company fund an acquisition or other growth initiatives, as growth opportunities are identified.

Some Common Private Equity and Financial Terms:

Call: means an amount of capital called by a company or private equity fund from shareholders. Shareholders in a private equity fund typically pay their committed capital in a series of capital calls over time. Calls are subject to specific notice and payment terms.

Capital Structure: means the proportion of a firm's permanent long term financing represented by debt, preference shares, ordinary shares and retained earnings.

Cash Multiple: means the multiple of cash invested by the private equity manager relative to both the proceeds derived during the investment period and at exit.

Committed Capital: means the total investment commitment by an investor to the private equity fund (a function of the number of shares subscribed for by the investor and the share issue price). The investor will usually pay the committed capital in a series of calls over a period of time.

EBITDA: means earnings before interest, tax, depreciation, and amortisation.

Enterprise Value: means a company's total value. Calculated as the value of equity plus debt and preferred shares, minus cash and cash equivalents.

Exit: means the sale or realisation of an investment by the private equity manager. This is typically achieved when a portfolio company undertakes an IPO, or is acquired by, or merges with, another company.

IPO: means initial public offer, the offer of shares in the company to the public, usually accompanied by the company listing on a stock exchange.

IRR: means internal rate of return, a measure of return based on the cash invested and cash proceeds over a period of time.

Leverage: means the use of borrowed funds to finance a portion of the cost of an investment.

Succession Plan: means the planned transition of business ownership from one ownership group to another.

Investee or Portfolio Companies: Companies that a private equity fund has invested in.

Case study: Example of a Private Equity Transaction

Imagine a company Arlo Limited ("Arlo"). Arlo generates earnings before interest, tax, depreciation and amortisation ("EBITDA") of $5 million.

The owner has been operating the company for some years and it is the owner's major personal asset. The owner believes there are growth opportunities for Arlo but it will require new capital to be invested, and new expertise around the board table would also be an advantage.

Investment

PEI Fund, a private equity manager, offers to invest new funds into the company to fund the growth opportunities, buy a portion of the owner's existing stake to enable the owner to realise some value, and take a position on the Board.

The equity of Arlo is valued at $25 million (Arlo has no net debt at the time), based on a 5 times multiple of Arlo's EBITDA. PEI Fund acquires 20% from the owner at a cost of $5 million and invests a further $5 million into the company. PEI Fund's total investment is $10m for a 33.3% stake. The owner retains 66.7% and has received $5m cash.

Acquisition

Over the next two years, Arlo successfully utilises the cash injection to pursue growth opportunities, and increases EBITDA to $8 million. Arlo identifies an opportunity to expand its market share by acquiring a competitor, Siro Limited ("Siro"). Siro has an EBITDA of $5 million and an equity value of $25 million (based on the same EBITDA multiple applied to Arlo and assuming Siro has no net debt).

The increased scale of the combined businesses, combined EBITDA is $13 million, enables Arlo to borrow $25 million of bank debt to fund the acquisition. Arlo's debt level represents 1.9 times the combined EBITDA (generally regarded as a conservative level of gearing).

Exit

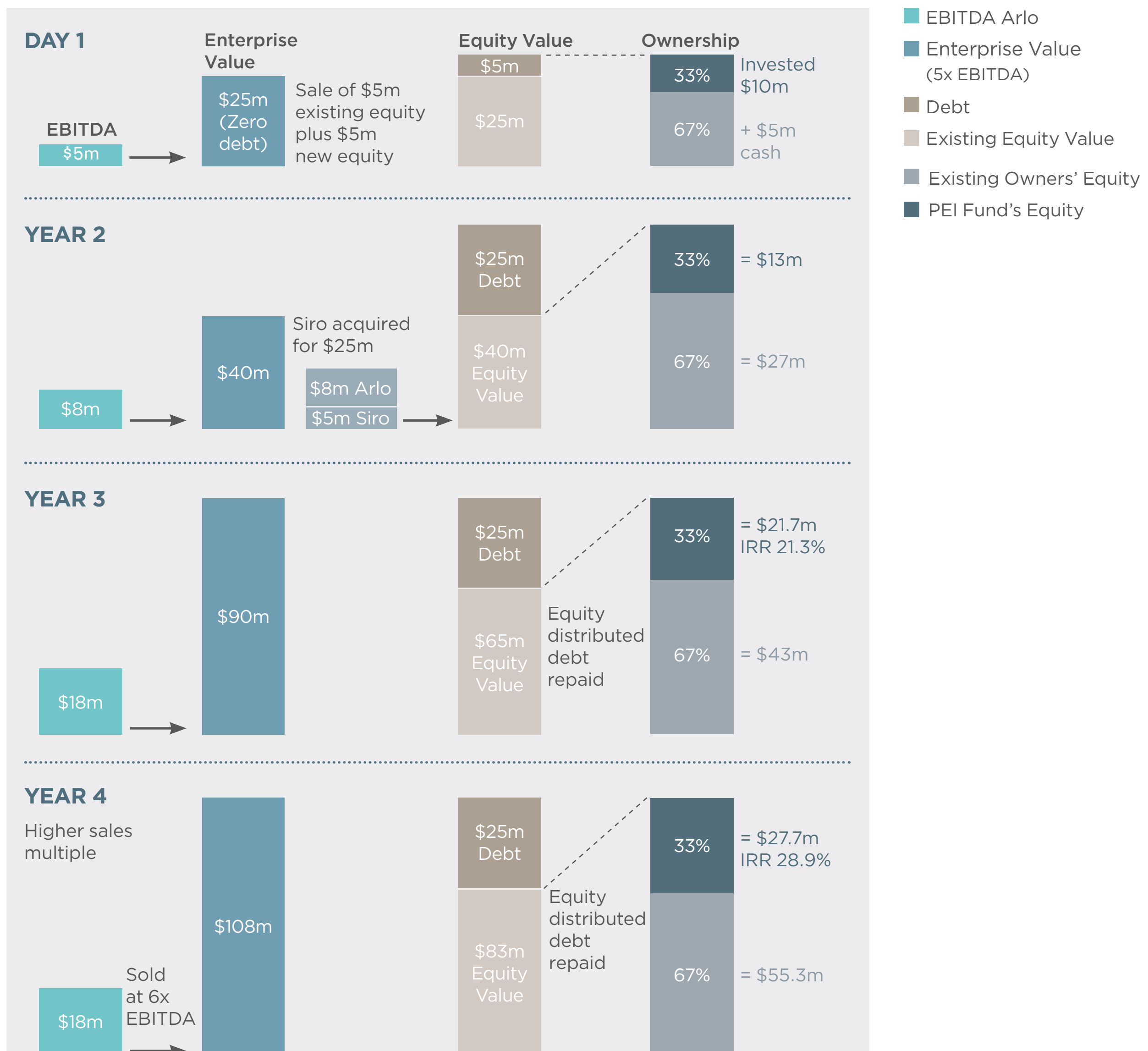
Following the acquisition and a further two years of trading, Arlo has grown EBITDA from $13 million to $18 million. The shareholders decide to exit the business.

Assuming an exit at the same multiple of earnings (5 times EBITDA), the enterprise value of the business is $90 million. Deducting Arlo's debt of $25 million, the value of the equity is $65 million. For its 33% stake, PEI Fund receives $21.7 million from the sale and the owner receives $43.3 million for its 67% share. PEI Fund's investment in Arlo produced an IRR of 21.3% per annum and a cash multiple of 2.2 times its initial $10 million investment.

Typically, the increased size of Arlo would result in an acquirer attributing a higher EBITDA multiple when valuing the business. Assuming Arlo is valued at 6 times EBITDA, PEI Fund's stake would be worth $27.7 million and it would have achieved an IRR of 28.9% per annum.

Note: the calculation of returns above has been simplified by excluding any dividend or other distributions from Arlo to shareholders during the period of the investment. The example is illustrative of a private equity transaction only and should not be used to estimate or project private equity returns.

Arlo Private Equity Example



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