Guide on Private Equity and Venture Capital for Entrepreneurs

An EVCA Special Paper

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This guide has been prepared with support from the European Commission to provide staff of the Euro Info Centres with a better understanding of private equity and venture capital.

European Private Equity &
Venture Capital
Association

About EVCA

The European Private Equity and Venture Capital Association (EVCA) was established in 1983 and is based in Brussels. EVCA represents the European private equity sector and promotes the asset class both within Europe and throughout the world.

With over 1,200 members in Europe, EVCA's role includes representing the interests of the industry to regulators and standard setters; developing professional standards; providing industry research; professional development and forums, facilitating interaction between its members and key industry participants including institutional investors, entrepreneurs, policymakers and academics.

EVCA's activities cover the whole range of private equity: venture capital (from seed and start-up to development capital), buyouts and buyins.

Disclaimer

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1. Introduction

Starting and building a prosperous business is an ambition of many Europeans and Europe's main source of job creation. But the European Union is failing to capitalise on this entrepreneurial potential. Although 29% of European small and medium-sized enterprises (SMEs) say that growth is their main objective, too few manage to achieve it ([1]).

Getting a company off the ground and/or expanding it requires money, and raising the right kind of finance is still a major difficulty for Europe's SMEs. The lack of capital is a barrier to growth that can rarely be overcome by recourse to family, friends, business angels ([2]) or banks.

Overall, 75% of the Europeans consider it difficult to start their own business due to a lack of available financial support. In this respect, the situation in the new European Union Member States has considerably improved from 84% in 2004 to 77% in 2007 ([3]).

Private equity and venture capital is an increasingly important source of finance for European high-growth potential companies. The goal of private equity and venture capital is to help more businesses achieve their ambitions for growth by providing them with finance, strategic advice and information at critical stages of their development.

Although overall awareness of private equity and venture capital in Europe has improved in recent years, a clear understanding of its mechanics is required. This is even more obvious in the case of smaller firms and family-owned businesses. The lack of information, together with the fear of relinquishing control through the exchange of shares for cash flow, hamper those companies to call on private equity and venture capital.

A 2004 survey ([4]) of 2,500 entrepreneurs across 15 European countries showed that the risk of losing control was the deciding factor for not calling on private equity and venture capital (24%), followed by the lack of information on how private equity and venture capital operates (23%).

However, despite this, 80% of the entrepreneurs who approached private equity and venture capital investors welcomed the improvement in their business activities and in their budgetary and financial monitoring. In a similar vein, the investors' experience and network of contacts were also regarded as very positive elements. Furthermore, having private equity and venture capital investors provided the companies with more credibility with their clients, suppliers, banks and competitors. This is particularly true for start-ups, which assets are often intangible and which have to provide numerous guarantees.

([1]) European Commission Observatory of European SMEs.
([2]) A business angel is a private investor who provides both finance and business expertise to an investee company.
([3]) Source: Flash Eurobarometer on Entrepreneurship 2007.
([4]) "Awareness & Perceptions of the Venture Capital/Private Equity Industry", conducted on behalf of EVCA by EOS Gallup Europe, April 2004.

1. Introduction

This guide has been prepared to introduce and demystify the private equity and venture capital industry to entrepreneurs searching for external capital. It will help to answer questions such as:

- Why should I call on private equity and venture capital?
- Which are the types of companies private equity and venture capital investors are looking for?
- How do I select a partner?
- How do I prepare a business plan?
- What should I expect from this partnership?

The guide aims to provide a comprehensive insight into the private equity and venture capital business model and investment process. It includes not only a description of the relationship between the entrepreneur and the private equity fund managers, the stages towards an eventual agreement, the follow-up to and the exit from an investment, but also how funds are structured.

This guide is not a substitute for more specific advice on building a deal, accountancy, tax or company law.

2. The Contribution of Private Equity and Venture Capital to the Economy

Private equity and venture capital plays a critical role in driving Europe's growth and jobs. Since 2000 private equity and venture capital professionals have invested more than €270 billion in over 56,000 companies in Europe. 2006 was a year of record equity investment of €71 billion in over 7,500 European companies (5).

Private equity and venture capital enables companies to grow and develop, and supports companies which would have had lower growth or would not have been able to survive without it (6). It improves the performance of thousands of companies and allows the development of new technologies and their applications. The industry's focus on improving fundamental business performance means that private equity and venture capital investment may be one of the most potent forces driving economy-wide improvement in corporate productivity.

Between 2000 and 2004 European private equity and venture capital financed companies created 1 million new jobs (7), which translates to a compound annual growth rate of 5.4% per year (eight times the EU25 total employment growth rate of 0.7%).

When the Financial Times studied the 30 largest European private equity transactions in 2003-04, it reported that "overall, jobs were more likely to have been gained than lost as a result of private equity-backed buys."

European companies such as Skype, Mobistar and TomTom have benefited from private equity and venture capital to become global leaders.

The big winners benefiting from the returns made by private equity and venture capital firms are their institutional investors, mainly pension funds, which in 2006 continued to be the industry's single largest source of capital, accounting for 27.1% of the total funds raised, thus bringing the financial gains back to millions of pensioners and saving account holders.

(5) Source: EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity.
(6) Sources: EVCA "Survey of the Economic and Social Impact of Venture Capital in Europe", June 2002; EVCA "Survey of the Economic and Social Impact of Management Buyouts & Buyins in Europe", January 2001.
(7) Source: EVCA survey "Employment Contribution of Private Equity and Venture Capital in Europe", November 2005.

3. Private Equity and Venture Capital as a Source of Finance

3.1. Private equity: a definition

Private equity is the provision of equity capital by financial investors – over the medium or long term – to non-quoted companies with high growth potential ([8]).

Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the launch, early development, or expansion of a business. It has a particular emphasis on entrepreneurial undertakings rather than on mature businesses.

Private equity covers not only the financing required to create a business, but also includes financing in the subsequent development stages of its life cycle. When financing is required by a management team to buy an existing company from its current stakeholders, such a transaction is called a buyout ([9]).

Private equity and venture capital may refer to different stages of the investment but the essential definition remains the same: it is the provision of capital, after a process of negotiation between the investment fund manager and the entrepreneur, with the aim of developing the business and creating value. For the sake of simplicity, from this point onwards, the term private equity will be used to cover both venture capital and buyout.

Private equity firms have a main goal: seek out companies with the potential for growth and with the aim to put in place the capital, talent and strategy needed to permanently strengthen the company and raise its value.

Private equity is often categorised under the umbrella of "alternative investments", complementary to the stock and bond portfolios traditionally used by investors.

3.2. Is private equity right for your business?

Each business has its own ambitions, abilities and needs and not all will be suitable for private equity. The following questions are designed to help you assess whether private equity is right for you. If your answers are predominantly "yes", then private equity is worth considering. If there are too many negative responses, it will be difficult for you to interest private equity investors.

- Are you prepared to take on the responsibility of being an entrepreneur, i.e. to run a business with a method and structures, to delegate responsibilities to a team and know how to motivate them, to develop your knowledge outside the business and bring this knowledge into your company, to take on the legal responsibilities – in a word, to take the plunge?
- Are you prepared to give up part of your company's capital to a private investor?
- Does your business operate in a growth market?
- Are your company's development prospects sufficiently ambitious?
- Is your team prepared to follow you? Does it have the necessary experience?

([8]) For a definition of a high-potential company, please see the EVCA Barometer of May 2005: Identifying a high-potential company.
([9]) When the management comes from the target company (which is often the case), the investment is referred to as a management buyout (MBO). If the new management team comes in from outside the target company, the investment may be referred to as a management buyin (MBI). In a buyout deal, a significant amount of the financing required is often provided by bankers and other lenders in the form of various types of debt. If there is an important proportion of debt, the buyout is called a leveraged buyout (LBO).

- Does your company have a certain technological or competitive advantage that can be developed or exploited?
- Are you prepared to share certain strategic decisions with shareholders outside your “inner circle”?
- Is there a realistic exit strategy for all shareholders?

These and other important questions that will come to you as you read this guide, are the kind of questions that investors will quickly ask you.

Private equity is an option worth exploring when you want to:

- create a business;
- improve and develop your export performance;
- exploit the creativity and innovation of your team;
- recruit highly qualified personnel;
- sell part or all of your company;
- change the size of your business and take over one of your competitors;
- launch a new product;
- improve your management capacity;
- liquidise some of your assets.

What does a private equity firm bring to you?

- Long-term capital, solidly underpinning your company’s growth;
- increased visibility with bankers, suppliers and clients;
- a partnership, sharing the risks and the rewards;
- an investment fixed within the framework of a negotiated contract;
- the adoption of high-performance management standards;
- strategic and operational support along with financial advice in times of crisis;
- assistance with subsequent financing operations;
- alliances due to the investor’s network of contacts and portfolio of investments;
- a partial or total exit strategy.

What is a private equity firm looking for?

- High growth, competitive products or services;
- in the case of disposal or transfer, a loan capacity and recurring profits;
- a quality and stable management team, capable of turning the negotiated goals into reality;
- solid management procedures, either already in place or able to be quickly put in place;
- a transparent legal structure where personal and professional assets are not entangled;
- an agreement on the investor’s exit, with or without the head of the company.

3.3. Is there an alternative to private equity?

There are several alternatives to private equity: self-financing, debt or raising capital via a stock market flotation.

- **Private equity versus self-financing**

  Self-financing, either on your own, by friends, family, or business angels can be relatively easy and quick but it is seldom a viable long-term solution for a growth business. Personal relationships can become entangled with the business and the joint shareholders rarely play an effective role in supporting the entrepreneur.

  On the other hand, professional investors can mobilise a great deal of capital, support growth and help the entrepreneur but the process can be long and may mean giving up more of the equity in the company.

- **Private equity versus debt**

  As creditors of the company, lenders demand guarantees – either personal or from the company. Companies with few or no assets, or entrepreneurs already deeply involved in their project, will find it hard or even impossible to produce these guarantees. However, the loan has no impact on the share structure of the company and the lender will not intervene in the running of the company.

  By comparison, a private equity investor brings capital, does not require interest payments, is subject to the risks of the company like any other shareholder and will only profit if the company grows. He has specific controlling rights over how the company is managed. When an entrepreneur seeks a private equity investor, he is looking for a long-term partnership to help him with the next few stages in his company's life cycle.

- **Private equity versus raising capital via a stock market flotation (see Chapter 8)**

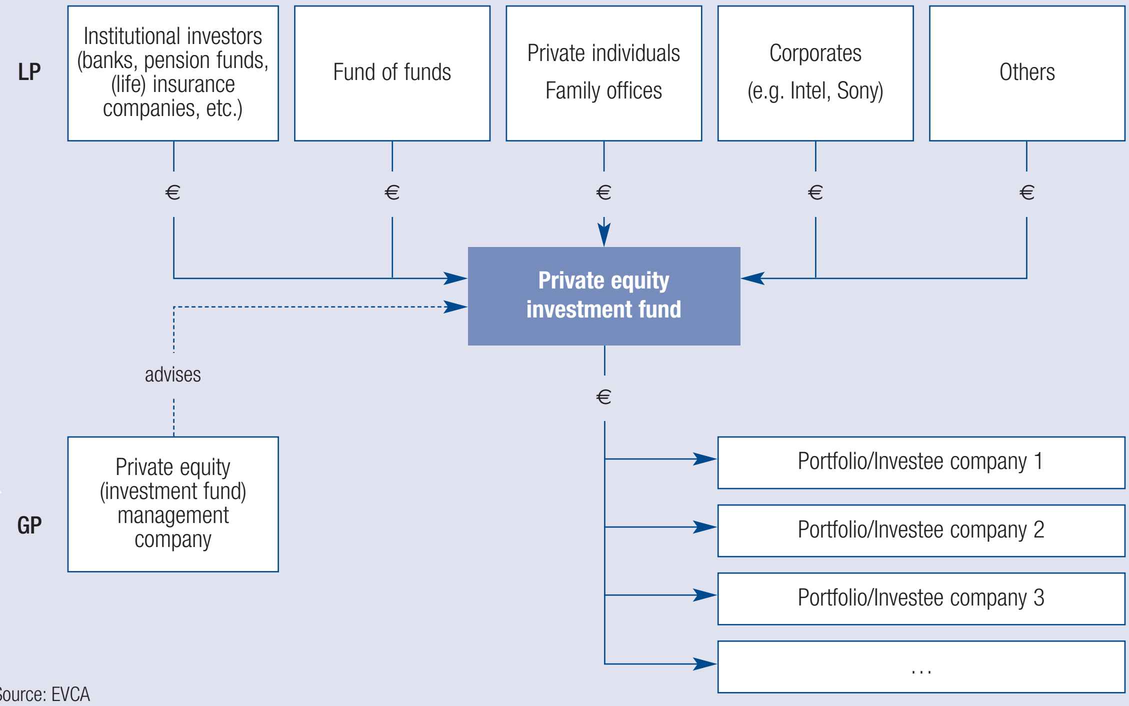
  A private equity investment is a medium to long-term investment, which does not provide the same liquidity as a stock market flotation and which ties the investor closely to the company. The investment is more secure because it is less vulnerable to external economic fluctuations. The closed structure of a private equity fund prevents fund managers from exiting prematurely and strengthens the long-term engagement of the fund in the companies in which it invests.

  On the other hand, a stock market flotation requires that the company has already reached a certain level of activity, as well as regular public reporting and control by stock market regulators.

4. The Private Equity Business Model

The private equity business model involves different players (see figure below) and can be broken down into four main phases.

Figure 1: The private equity business model



Source: EVCA

4.1. Creation of a fund and underwriting by professional investors

After obtaining the agreement of the controlling authorities, private equity firms (known as private equity management companies or General Partners (GPs)), establish investment funds that collect capital from investors (known as Limited Partners or LPs). The private equity firms use this capital to buy high-potential companies (known as the portfolio or investee companies).

Thus, private equity fund managers invite institutional investors and individuals with particular expertise or significant assets, to subscribe to an investment fund for a set period (on average ten years), which will take equity stakes in high-potential companies following a clearly defined investment strategy. This can be according to the size of the target companies, their sector, stage of development and/or geographical location. These investors are often known as “sophisticated or professional investors”, because they understand the risks inherent in this type of operation.

The fundraising period lasts for six months to one year.

4. The Private Equity Business Model

As investment funds are for the most part closed, institutional investors cannot leave those funds before their term (or they will have great difficulty in doing so). This financial stability is one of the clear advantages for the entrepreneur who seeks a private equity investment.

In exchange for the money they provide, investors receive a pre-negotiated stake in the equity of the investment fund and they become fully-fledged shareholders, sharing in the risks associated with the private equity firm.

The investors' aim, through the fund, is not to take control of the portfolio company (with the particular exception of majority shareholdings) but to help create value in order to realise a capital gain – shared with the owners – on exit.

This type of financing is often called "patient capital", as it seeks to profit from long-term capital gains rather than short-term regular reimbursements.

4.2. Investing the fund

Once the target amount of capital has been raised, the subscription is closed. The private equity investment managers then seek high-growth companies to invest in, following the investment strategy they proposed to the institutional investors.

In some cases (30% on average) ([10]), private equity investment funds will come together and form a "financial syndicate" to make an investment. This will happen if the risks are high or if the amount of capital required in the operation is particularly substantial. One of the investment funds will represent the group in the syndicate's dealings with the entrepreneur. This representative will follow a mandate negotiated with his partners.

The average private equity fund size in 2006 was €322 million ([11]), ranging from small seed capital funds of less than €10 million up to large buyout funds managing several billion euros.

The private equity management team essentially makes investments in the first five years of the fund.

4.3. Managing the investment

The fund managers run their investment operations and prepare exit strategies depending on market conditions, agreements drawn up in advance with the entrepreneurs and opportunities for disposal.

Because the fund manager on behalf of the investors is concerned with creating value in the company, he will follow his investment over the long term and will participate in any subsequent rounds of financing required.

([10]) Once again in 2006, 69.9% of the investments by number, €52.2 billion by amount, did not involve any syndication. Investment with national syndication increased to 22.8% by number of investments in 2006 from 19.1% in 2005. Transnational syndication increased to 7.3% by number of investments from 5.9% in 2005. Source: EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity.

([11]) Source: Thomson Financial.

4.4. Redistribution

When fund managers decide to exit their investment (see Chapter 8), the capital recovered from the exit is redistributed to the original investors on a pro-rata basis depending on the size of their initial investment. These reimbursements, along with the capital gains, allow the institutional investors to honour their insurance contracts, pensions or savings deposits.

Institutional investors are looking for significant profit from their investment to compensate for the fact that their capital is tied up for long and to ensure that they can reimburse the money allocated to them by their clients (the savers and pensioners).

When all the capital collected from the investors has been invested and when certain investments have already been exited, the fund managers may launch a second fund. Their credibility in attracting new investors depends on their historical performance because they will be in competition with other managers in the asset management market.

5. The Different Types of Private Equity Investment Funds and what they Specialise in

Private equity funds differ in their areas of specialisation, their shareholders and their management structures. The source of a private equity fund can affect the structure of the deal offered, can determine whether the fund manager can make a rapid investment decision or not and even have an impact on the continuity of the people you deal with and their management style once the capital is invested.

Independent private equity funds are those in which third parties are the main source of capital and in which no one shareholder holds a majority stake. An independent fund is the most common type of private equity fund.

Captive funds are those in which one shareholder contributes most of the capital, i.e. where the parent organisation allocates money to the fund from its own internal sources. Captive funds can be subsidiaries of or departments in a bank, a financial institution, an insurance company or an industrial company. So-called corporate or industrial funds are launched by companies looking to invest in sectors relevant to their core activities and to identify new technologies. This can also be the case for banks that want to separate their role as a commercial banker from their role as an investor.

Semi-captive funds are funds in which, although the main shareholder contributes a large part of the capital, a significant share of the capital is raised from third parties. Semi-captive funds can be subsidiaries of a financial institution, an insurance company or an industrial company that operate as an independent company (certain corporate funds fall into this category). ([12])

For captive and semi-captive funds as a compensation for less independence for the management company, the parent company assumes most, if not all of the responsibility for finding the capital required for the investments.

Some funds come from the public sector. Their capital comes mainly or totally, directly or indirectly, from public bodies.

5.1. How do private equity investment funds work?

The legal structures relating to private equity investment funds vary from country to country but there are two main types: funds with a limited lifespan, in general ten years, and funds with an unlimited lifespan.

The former is the most common, based around a partnership agreement between the institutional investors and the investment fund management team. The most frequent legal structures used are the Anglo-Saxon Limited Partnership, the FCPR (*Fonds Commun de Placement à Risques*) in France and other similar forms such as the SICAR (Luxembourg), the Private PRICAF (Belgium) or the Italian *Fondo Chiuso*. The fund managers (GPs) have unlimited liability for the investment whilst the institutional investors (LPs) are liable only for the amount of capital they have provided and do not play an active role in the management of the investments.

The management team (usually fairly small – on average between six and eight managers) draws down the funds in blocks of cash as and when they need the capital for their investments. To cover operating costs, a management contract is usually drawn up allowing for fees of around 1.5% to 2% of the capital raised to be deducted in advance from the investors' commitments.

([12]) In 2006, independents provided two-thirds of the total European amount invested and captive funds invested €12.5 billion or 17.6% of the total investment amount. Semi-captives invested €10.4 billion, representing 14.6% of the European total. Source: EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity.

The fund managers are in effect themselves entrepreneurs involved throughout the lifespan of the fund. They check that their management company is running in a balanced fashion.

On exit from an investment (i.e. divestment), the amount recovered is usually not reinvested but redistributed to the capital providers. The institutional investors receive the first part of the profit, and an agreed target rate of return or "hurdle rate" ([13]), as a reward for tying up their capital over the lifespan of the investments.

If there is a surplus profit above the hurdle rate, this is shared between the fund managers and the other investors. While the fund managers are usually entitled to 20% of this capital gain, the LPs will receive the remaining 80%. This 20% of the profit above the hurdle rate is called "carried interest" or "carry".

After ten years (sometimes an extension to twelve years is granted), all the investment in the portfolio must be divested and the investment fund must be closed.

The overall performance of the fund and its management team is assessed by calculating the internal rate of return (IRR), the net difference between the capital invested and the money reimbursed to investors. This rate depends not only on the amount returned but also on the length of time for which each block of capital was tied up.

Funds with an unlimited lifespan do not operate with the same time constraints as the funds described above. However, the managers also come together in a management company and manage their investments under the same conditions. In the past few years, these managers have been rewarded in the same way as their counterparts described above. They usually reinvest part of the realised capital gains into the fund.

Fund specialisations

Fewer and fewer funds are purely generalist (i.e. with no sector or business type specialisation) and the majority of private equity funds have decided to specialise in certain industrial sectors or services or in companies at a certain stage of development, of a particular size or with a specific geographical coverage (regional, national or international).

5.2. The different stages of a company's development

Funds can vary widely depending on the different stages in a company's life cycle, which can be defined along the following lines, keeping in mind that the boundaries between the different stages can be blurred.

Seed

Seed financing is designed to research, assess and develop an idea or initial concept before a company has reached the start-up phase.

At this stage, investors are mainly business angels. They are often entrepreneurs or former directors who join a project to help get it off the ground and contribute some of their personal funds. Recently, there has been an increase in the number of business angels.

([13]) The hurdle rate is a rate of return that must be achieved before a manager becomes entitled to carried interest payments from a fund.

5. The Different Types of Private Equity Investment Funds and what they Specialise in

Though it is rare for specialised financial operators to contribute capital to such ventures, there are some "seed" experts. This "seed money" accounted for 0.3% of the total capital invested in 2006 by the European private equity and venture capital industry [14].

Start-up

Start-up financing is used for product development and initial marketing. Businesses may still be in the creation phase or have just started operations and have not yet sold their product commercially.

When the product has taken shape, forming the basis of a real "business plan", a certain number of venture capital professionals will join the entrepreneur and assist him with setting up the business.

At this stage, the capital is mainly required for research and development of the product and to train personnel. This is especially true in technology sectors such as electronics, IT, life sciences or biotechnology.

The risk of failure for these companies is high and investors need to be stringent in their choice of projects.

Post-creation

At this stage, the business has already developed its product and needs capital to begin making and selling it. It has not yet generated any profits.

Expansion/Development

In the case of expansion, the business has reached or is approaching breakeven. This is a period of high growth and capital is used to increase production capacity and sales power, to develop new products, finance acquisitions and/or increase the working capital of the business.

Getting through this period often requires many rounds of financing, during which the company has to ensure that its growth is balanced. Professional investors are most attracted if a significant amount has already been invested in a company, if the company already has a history of development and if it is already operating with a robust structure in place.

This stage includes bridge financing [15] and rescue or turnaround [16] investments.

Transfer/Succession

The total or partial retirement of the head of a company is often an opportunity to implement a leveraged operation (capital contributions in the form of both debt and equity) to undertake a buyout or a buyin. These can also happen when a large company disposes of a business unit, or when shares held by family members are repurchased or, eventually, when investors from previous stages of development exit the business.

[14] Source: EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity.
[15] Financing made available to a company in the period of transition from being privately owned to being publicly quoted.
[16] Financing made available to an existing business which has experienced trading difficulties, with a view to re-establishing prosperity.

The existing management team (in the case of a buyout) or a new team (in the case of a buyin), assisted by financial investors, creates and finances a holding company that then borrows debt to acquire the target company. The dividends produced by the target company then enable the holding company to repay its debt. The structure of this operation means that it applies only to an established company or business unit, with a positive and/or predictable cash flow.

Buyouts (or buyins) allow a company to carry on trading, facilitate generational change at the top of a company, enable restructuring more efficiently by injecting fresh capital and protect jobs whilst safeguarding employees' shareholdings. The contribution of the private equity investors is not simply financial: they support the company management by bringing in their knowledge of the industrial sector, their network of contacts and their long-term commitment. The amounts invested are typically substantial and big investment funds have specialised in these operations for many years.

5.3. Investment size: majority versus minority investments

The size of investment is often linked to the company's stage of development. Private equity investors often take a substantial share in very young companies because they supply capital that is very difficult to raise from traditional sources (such as banks) and because they are heavily involved in setting up the operation. Very young companies require great assistance because the head of the company has to divide his time between product development and more general management. Here, the support of private equity investors is very important. However, the amounts invested are smaller than in development or subsequent stages.

During buyouts, private equity investors are also often majority stakeholders in the companies. However, they can be minority stakeholders during the development stage if the company is already active and is looking for capital to "complete" its development.

But regardless of the size of the initial stake, agreements often allow for equity to be returned to the investee company managers or entrepreneurs when they have achieved certain objectives. In this way, the private equity investor can move from being a majority stakeholder to holding a minority stake.

5.4. The size of the investee company

Contrary to commonly held beliefs, private equity is very active in small and medium-sized enterprises. In 2006, 89% of the private equity backed companies in Europe had fewer than 500 employees and over 70% had less than 100 employees.

The biggest operations (in companies with over 1,000 employees) represented less than 9% of the total number of investments in 2006 but accounted for 49% of the total European capital invested ([17]).

Over the past five years (2002-2006), over €90bn has been invested in companies with more than 1,000 employees, across 1,854 operations. While this represents 42.9% of the total European amount invested in that period (€212bn), it accounts for only 3.5% of the total number of investments (52,512) ([18]).

([17]) Source: EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity.
([18]) Sources: EVCA Yearbooks 2003-2007.

5.5. Sectors

Sector specialisation allows investors to make better evaluations of a business. The entrepreneur is able to deal with a specialist in his sector with whom he can share his strategic thoughts.

In 2006 the sectors that attracted the highest interest from private equity in Europe (in terms of amount invested) were consumer-related and non-industrial or financial services, together accounting for over 30% of investment, followed by communications, healthcare (including medical) and computer-related. The largest number of investments were made in computer-related, healthcare and consumer-related companies ([19]).

5.6. Geographical scope of investments

In 2006, €67.7 billion or 95% of the total European amount invested went to companies that were based in Europe.

85% of the total number of investments were made in the country where the fund is based, 10% were invested in other European countries and 5% outside of Europe ([20]).

Being close to the business allows for a better relationship. This is particularly true for financing operations during the early stages. In big operations or when the operation is syndicated between several investors or when the business is more mature, geographical proximity is less important.

([19]) Source: EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity.
([20]) Source: EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity.

6. Looking for an Investor and the Investment Process

If you decide to approach a private equity firm, a long process of preparation, negotiation and finalisation is ahead of you. You need to devote a lot of time and energy to each of these stages.

The first thing to understand is that private equity cannot fund every company. Due to the nature of its financing model, private equity funds need to ensure a higher profit than other types of investments available to institutional investors (to compensate for the amount of time the capital is tied up). The private source of the capital and the need to be involved with the companies financed over the medium and long term, dictates that only the most dynamic companies or those with the greatest potential for growth are selected.

The number of investment opportunities available to a private equity firm is called deal flow. Good-quality deal flow is an essential factor in the success of a private equity firm. The fact that less than 5% of business plans received by private equity players result in the fund taking an equity stake in the company shows how selective the process is [21].

Private equity firms only invest in companies – or future companies – that correspond exactly to their investment criteria. Even in cases where those criteria are met, a long process of analysis could still lead to refusal if no agreement can be found on the entry price or if the detailed analysis (due diligence) shows that the investment proposed does not correspond to the expectations.

A refusal to invest does not mean that your project lacks quality. It means that the characteristics of your project do not match the set criteria of the firm you have contacted. Or it may mean that the private equity fund has already invested enough in your area of activity. Not all projects can be funded by private equity and your company's stage of development may not yet match the private equity fund's criteria. However, it is useful to know why an investment opportunity has been rejected. This can sometimes allow you to adjust your projections, to deepen your study of the market or to make some changes to your team before approaching other investors.

6.1. Writing a business plan

The process of attracting private equity starts with the preparation of a business plan, which is then sent to various private equity firms. The business plan is the main tool used by the financial investor to evaluate the prospects for the business. Above all, it is the first point of contact with the investors. The company management should prepare and write the business plan. Private equity investors will want to learn what the entrepreneur and his management team are planning to do.

A business plan (or development plan) fulfils two main functions:

First, it forces the business's management team to fix their objectives. It encourages them to think hard about the business, to identify what it is they are offering and to set strategies. The entrepreneur and his team must have a clear vision of their business activities. They must forecast the performance they expect and set out the business model they will use. All this must then be translated into the business plan, which covers all these strategic choices. Your business plan will either confirm or rule out your wish to seek private equity.

[21] Source: EVCA Barometer September 2007: Further increase in the number of business plans received by European VCs in 2007.

Second, the business plan is the point of contact with the investors you approach. Your business plan should express the unique essence of your company. It must arouse the interest of the investors and tell them exactly why your business or project deserves their serious attention.

Private equity firms receive hundreds of business plans every year. You need to convince them that your business activity and your prospects have something special about them. In a few pages, free of jargon and vague generalities, the plan must clearly show the nature of your business activity, your objectives, the means of achieving them whilst remaining realistic, and all without hiding potential weaknesses and challenges.

In its full version, the business plan will extend to some 30 or 40 pages. You should also have a shortened version – four to six pages – that serves as the first point of contact with investors.

The precise content of a business plan depends on the special characteristics of each business, but several points are common to all and must be included.

The essential points to cover:

- **The executive summary**

  The executive summary is the most important section. Even if it appears first in your business plan, it should be the last thing you write. This is because it summarises, in just a couple of pages, all your analysis and sets out your strategy. How compelling you make the content will decide whether or not the investor continues reading. However, it should not be a "marketing" message. Rather, it should present both the logic behind your business activity and the organisation behind the proposal. You should not hide weaknesses and challenges but you should acknowledge them and then show how you intend to overcome them.

- **Company history**

  This is a summary of how the business has evolved and its past performance. In the case of a start-up company, it is a summary of the stages leading to the creation of the project.

- **Management team**

  This is an important section because you have to show that the current team – or the team that you have in mind – will be able to deliver the business plan. Will the team be able to follow you during the development and transformations you envisage? You should set out the experience, motivation and past achievements of the main members of your team.

  Identify the gaps in your organisational chart which need to be filled for your project to be a success. The private equity investors will be able to help you fill them.

  Introduce your auditors as well as all your advisors (see below). Introduce also your independent directors, whose collaboration and experience are vital.

  Explain the performance measures you have used and the remuneration packages for your managers and employees.

- **Products and services**

  Your products or services should be presented in a simple fashion, especially if they are high-tech products. You need to stress their competitive advantages, what their stage of development is, possible weaknesses and what patents are, or could be, registered. What advantages do they offer over your competitors? Why are your products better than theirs?

- **Analysis of your market and your competitors**

  Are your products attractive? Where is the demand going to come from? These are fundamental but often poorly analysed questions and they are often the reason why many young innovative companies fail. Demand projections are often too optimistic and the competition frequently underestimated.

  Regardless of whether this is a new business activity, the development of an already existing activity or a business disposal, you should show how the market in general is progressing and what is happening in your particular segment. You should also describe the strategic positioning of your competitors, the barriers to entry in the market, the distribution channels, past production difficulties, potential risks and your responses to these risks.

  For certain sectors, regulatory constraints and how these are likely to develop are also important considerations.

- **Commercialisation**

  Now you need to show how your business – or future business – will respond to the market potential you have identified.

  This is where you define your distribution strategy (national or international), according to the market you are in and adapted to your clients' needs. How are you going to get across to them the real value of your products? Over what timescale?

  This is the point at which you define your pricing strategy and how you intend to differentiate yourself from your competitors. In addition, you need to define your communications and promotion policies.

- **Operational management**

  You need to set out how your business is going to function on a day-to-day basis and what internal resources it has, whether this applies to your flow of supplies, R&D policies, social policies or possible partnerships.

- **Reminder of the main hypotheses behind the plan**

  Before presenting the financial projections, it is a good idea to remind the investors of the main hypotheses behind the business plan and to confirm the internal logic of the model. This includes how the proposed product or service responds to an opportunity in the market, how the instruments and resources required have been accounted for (commercialisation, team, finances and production), and what the main risks are.

  In this way, you can draw up a list of each of the elements developed in the previous sections and show whether they generate your revenue or form the basis of your costs.

- **Financial projections**

  Your projections need to be realistic and show the growth potential of your company. All hypotheses must be justified and linked to your previous analysis of the market. With the help of your accountant, you should question all your projections and ensure that your model is balanced.

  You need to prepare projected balance sheets covering the next three to five years, operating accounts and cash flow tables, if necessary, for all the different units of your business.

  The cash flow projections allow you to plan your liquidity needs and identify difficult periods so that you can prepare for them and avoid the risk of insolvency. Your balance sheets and operating accounts will enable the investment manager to check that his investment will be profitable over the whole period of the operation.

  Check all the key parts of the business and their effect on the overall balance of the company. What happens if turnover drops by 10%? What happens if the suppliers' costs rise by 5%? What happens to cash flow? What are the possible levels of debt? What is the highest sustainable debt/equity ratio?

  If your business already exists, you need to provide a history of your financial results in order to give some credibility to your projections.

  Finally, do not forget that investors are used to reading balance sheets and will be able to see quickly whether your projections are realistic. Your projections will also, in the end, serve to prove that the development plan is progressing as planned.

- **Capital required**

  The financial projections will determine the level and structure of your capital requirements. They will also make it easier for you to choose which combination of funding methods to use: private equity firms, bank loans, business angels, or other.

  State how much finance and which sources are required by your business and explain what it will be used for, when you will need it and how the share capital will be divided before and after the operation.

- **Exit possibilities**

  Indicate, according to your projections, when and how the investor will be able to exit from the investment (see further).

6.2. Selecting a private equity firm

Once you have prepared your business plan and received input from your professional advisors, you must now choose to which private equity firm you will send it. The selection of a private equity firm is a key step, which can appear to be something of a gamble. You should select only those private equity firms which investment preferences match the investment stage, industry and geographical focus, and investment size required by your business proposition. As one of the main reasons why entrepreneurs do not apply for private equity is a lack of information about the world of private equity (as mentioned earlier), it is easy to understand how difficult this choice is. However, to help you select a few private equity firms, you should gather information from professional associations of private equity firms and consider the advice from your own advisors and contacts (bankers, accountants, lawyers).

Private equity firms try to differentiate themselves through the quality of their services. They will share with you their experience, their information, their strategic thinking as well as opening up new alliances or bringing in new sources of capital.

This source of advice and support, which goes beyond the mere provision of capital, is crucial. Experience shows that less than half of private equity financed businesses select the investor offering the highest valuation (22). Instead, the added value created by his reputation, his knowledge of the market and his network of contacts are considered more important.

After sifting through your first selection, visit the websites of the private equity firms and request their presentation brochures. In this way, you can confirm your first selection and check that the investors selected match your criteria in terms of sector, size, capital, and geographical preference.

At the end of this selection period, you should contact two or three of them and send them a summary of your business plan, keeping a more detailed plan for your first interviews.

It is normal to worry about the confidentiality of the data you are giving out. All professional investors, if they are affiliated to a professional association, are subject to a Code of Conduct. You can ask them to sign a confidentiality letter after your first meeting but wait first to see if discussions are likely to proceed.

6.3. The negotiation process

There are several stages in the negotiation process between you and the private equity investment manager. The following list is given as an example and sets out the path that negotiations most frequently take. But every negotiation is different.

(22) "What Do Entrepreneurs Pay for Venture Capital Affiliation?" David H. Hsu, Journal of Finance, Wharton School, August 2004.

6.3.1. Presenting your business plan and first analysis

During the first contacts, the fund managers will want to confirm their initial impressions:

- Does your company have the potential to achieve sustained growth?
- Does the management team have the necessary skills?
- Does the probable return on investment justify the risks taken?
- Does the investment match the fund's investment criteria?

During these presentations, you will discuss your business plan in more detail. In the end, you should be willing to provide any additional information requested, covered, if you wish, by a confidentiality letter [23].

You should decide with the fund manager whether your respective goals and limits are compatible and will allow a real partnership.

Throughout these initial discussions and subsequent phases, you should bear in mind that the people with whom you are negotiating are the same people you will be working with for several years. Your relationship should be trusting and balanced if it is to survive the inevitable difficult periods and strategic differences that will follow. The relationship now beginning is for the long term.

When the discussions with a potential private equity firm have begun, you should ask to see a simplified presentation of their portfolio and the initial results of their investments, so you can judge their performance and the support they bring to the companies in their portfolio.

Some questions you can ask them might include: How many investments do they manage?, are the founders still present in the company they have invested in?, can you meet the heads of the companies concerned?, how many companies have already been divested?, do they continue to back up the companies they invest in by offering follow-on investments?, have they encouraged “business matching” for the companies in their portfolio?, do they help companies in difficulty by bringing in external experts?, has the fund management company been present since the beginning?, is the fund consistent in its investments?.

6.3.2. Initial negotiations

If the first contact is satisfactory, the investor will begin to negotiate the conditions of the transaction with you and will offer you an initial memorandum. This will set out the broad guidelines for future negotiations. The investor will then take each section of your business plan and verify or change it using his knowledge of the sector and his previous investments.

[23] A confidentiality letter concerns those directly involved in the engagement as well as the members of an eventual financial syndicate and external advisors. This agreement stipulates that any information obtained, other than information already in the public domain or already known by the investors, may not be made known to anyone else without your written authorisation and may only be used for this negotiation. The letters can be destroyed or returned to you upon your request. You can even demand confidentiality concerning the very existence of the negotiations, today or in the future. In return, you must agree not to make public the discussions underway and not to open negotiations with any competing investors and you must confirm that your business activity is legal. The letter includes the possibility of damages if this confidentiality engagement is broken by one of the two parties and stipulates when the agreement runs out.

Your advisors have an important role to play in helping you select the best proposals at each stage of the negotiations. It is not enough simply to compare the valuations you are offered. You need to analyse the non-financial aspects of the alliance under consideration: the role of the board of directors, investment conditions, strategy, exit strategies, how the shares could be sold, preferential rights, etc.

Also the legal and financial structure of the operation will be discussed. The financial structure of the operation should contain a good balance between the risks and returns anticipated by both parties. The structure will obviously be different depending on the type of operation envisaged: whether it is a start-up, a developing company or a disposal. Together with the private equity firm, you need to work out the value of your company or project.

Several sophisticated financial instruments are available to organise the investment and fund managers frequently use a combination of equity, debt and quasi-equity to respond to the specific needs of each business.

- Equity and debt are the classical means of financing.
- Quasi-equity instruments combine the features of debt and equity, and are unsecured and convertible on exit. Examples are mezzanine finance or subordinated debt [24].
- Mezzanine finance is less well-known and refers to loan finance that is halfway between equity and secured debt, either unsecured or with junior access to security. The lender requires a higher rate of return than on senior debt because the loan is unsecured and he may allow part of the interest to be paid off later in exchange for the option of transforming some of the loan into equity. This financing structure imposes a lighter burden on the cash resources of a developing company, allows the company to put off some interest payments and is less dilutive for the entrepreneur than a pure equity financing structure. Although more common for mature businesses, this type of financing is being used more and more for small operations.
- Preferential or priority shares are also used. These allow certain categories of shareholders a preferential right under specific circumstances (priority in receipt of dividends, a special right to information, special voting rights, etc.).

Staged financing enables the investor to release his financing at certain stages such as during the development phase or launching of a product, when the company enters foreign markets, or when it needs to increase its production facilities. By limiting his total investment to each one of these stages, the investor *ipso facto* limits his risk.

The negotiation may anticipate stock buy-backs (or warrants) for the management team once the company has achieved certain objectives set out in the business plan.

If the amount invested is especially large or the investment is judged particularly risky, the investor may opt to syndicate the operation among several investors. Syndication offers an obvious advantage for the investor, who limits his individual risk in the operation, but there are also advantages for you:

- it avoids a single investor holding a significant part of the equity;
- it allows the company to benefit from the combined experience of the syndicate;
- it allows you to draw on relatively more finance than if a sole investor were present.

[24] Debt that ranks lower than other loans and will be paid last in case of liquidation.

The price negotiated for the equity is of crucial importance. For you, it determines how much equity is transferred and the consequences for the control of the business. This amount could simply be the exact amount of capital required but you might also choose to give up more capital than you need to avoid having to make further calls on external finance (which take up much time and effort). For the fund manager the price will be the basis on which his eventual performance is judged, and the basis of his ability to give money back to his own investors and to benefit from part of the eventual added value.

In order to assure their affiliation to a well-known private equity firm, some entrepreneurs accept a lower entry price than they would have received from less well-known investors.

The price proposed by the investment manager depends on his profitability objectives. When he approached his own investors, he presented them with a profitability objective (known as the internal rate of return) and committed himself to doing his best to achieve it by selecting the best businesses and negotiating the correct entry prices.

If the price proposed is close to what you wanted, accept it. The provision of capital is more important for your company, and for yourself, in the long term, than small gains in the valuation process.

- Company valuation

  One of the areas which need to be covered in the agreement between the entrepreneur and the private equity firm is the value of the company.

  There is no pure quantitative method of valuing a company because the exercise is based on hypotheses that are always slightly subjective.

  This is why valuations are the subject of long negotiations and often differ from one investor to another. However, there are certain recognised methods (see below) and investors generally use a combination of those, depending on the type of the business they are investing in and how developed it is.

  It is difficult, for example, to apply conventional methods of valuation in the case of start-up companies consisting of intangible assets. These businesses have risky turnover and profit projections, and can rarely be compared to existing companies.

  Differences between you and the investor will occur arising from your respective long-term objectives. The investment manager wants to protect himself from risk and prepare his exit strategy whilst you want to finance the business and retain as much capital as possible. You are probably more optimistic than the investment manager about the future of your company, which will often represent most of your personal assets, than the investment manager, who is managing a portfolio of several companies. Your negotiating power will depend on how developed your business is but it is also in the investment manager's long-term interest to build a balanced relationship with you rather than imposing extreme conditions from the outset.

  When the investment is complete, you and the investor will find yourselves "on the same side of the table".

Valuation methods can be categorised into:

- Methods based on discounted cash flows.
- Methods based on comparing your company to other companies – quoted and unquoted – in the same business sector in terms of profits, cash flow, net worth, turnover, etc.
- Methods based on opportunity cost, i.e. the profitability offered by an investment with the same level of risk.

a. Discounted cash flow (DCF)

This method, and its variations, can be used when the company already has a positive cash flow, when this cash flow can be estimated with a degree of certainty and when the discount rate can easily be approximated. This rate is based on the rate of a risk-free investment, for example a state bond, to which a premium is added. The level of the premium depends on the estimated level of risk. There are several more or less subjective factors that the investor will take into account (the nature of the industry, the size of the business, the illiquidity of the investment, the rebate due to his minority equity position, how long the funds invested need to be tied up for, competition from other investors) and he will choose how much weight to attach to these factors depending on his experience, the agreed business plan and your own powers of negotiation.

This discount rate is applied to the cash flow over the investment period and the sum of DCFs determines the value of the company today.

In certain cases, the discount rate is not linear over the whole period. This is true for start-up companies, companies in very high-growth markets or companies with high debt. This method is insufficient for companies in difficulty or companies which activities are strongly cyclical.

b. Comparative methods

The most frequently used comparative method is known as the price/earnings ratio, using the estimated price/earnings ratio of a similar quoted company. This ratio is applied to the estimated earnings of the target company, in the belief that the markets have correctly assessed future values.

Since it is fairly simple, this method is widely used. It reflects fairly well the mood of the market in a specific sector, and it simplifies the hypotheses needed to estimate growth and risk.

However, several corrective measures need to be carried out and so the price/earnings ratio of an unquoted company is lower than that of a quoted company for the following reasons:

- its shares cannot be freely bought and sold (they are illiquid);
- its results can be more cyclical than those of an established company;
- the cost of making and monitoring a private equity investment is much higher.

Other comparative criteria are sometimes used in the same way:

- Price/EBITDA ratio (Earnings Before Interest, Taxes, Depreciation and Amortisation), which is more focused on the firm's operations and excludes exceptional items.
- Price/net worth ratio, which is largely calculated on the basis of accounting standards. This method does not apply to service-sector firms with few fixed assets.
- Price/turnover ratio, which can even be used for companies in difficulty.

Earnings and net worth are largely determined by how inventory, depreciation and exceptional charges are accounted for, but turnover is an almost intangible item. The price/turnover ratio is therefore more stable than the price/earnings ratio or the price/net worth ratio, but it does not reveal any problems related to cost control.

c. Opportunity cost

This method assesses the current value of different options available to the investor. In short, the investor will study the profitability of other investments with the same risk level and apply this to your company.

Whichever valuation method – or combination of methods – is used, be aware that start-up companies are financed almost exclusively with equity, based on the expected rate of growth. Earnings and cash flow are negative at the beginning and the concept of net worth has little value.

For these reasons, turnover, EBITDA and ratios not linked to cash or the balance sheet are used most frequently. Calculations based on opportunity cost are also of great help.

When the business has developed, and cash flow and earnings become positive, methods based on the price/earnings ratio or the discounted cash flow can be used.

For more mature companies, which financing includes a large portion of debt, the methods used most often are the DCF and price/EBITDA ratio.

- The offer letter

After the valuation stage is complete, the investor will send you an offer letter. Although the terms and conditions of this letter do not constitute a formal engagement, they sketch out the aims of the operation, its structure and the general conditions attached to the investor's proposal (warranties, veto rights, exclusivity periods, fees, etc.), subject to the outcome of the due diligence process, other enquiries and how the negotiations proceed from this point.

This offer letter should also set out the conditions for the next stage in the procedure, the due diligence process, and under what conditions the final terms of the agreement can be confirmed or changed.

The next stage starts when you have officially accepted the offer letter.

6.3.3. Due diligence

It is only after the conclusion of the due diligence phase that the investment manager will finally decide whether or not to invest in your company. He will devote a great deal of time and resources to the due diligence process and will call in external consultants. Lawyers, tax advisors, accountants, experts in insurance and environmental risk forecasting as well as intellectual property consultants, human resources consultants and specialists in the sector, among others, will help him analyse all aspects of the business and the information you have provided.

At this stage, the investor will have access to all necessary information and will be able to discuss any changes required in the organisation or the organisational set-up, based on the conclusions of the various studies and audits undertaken.

The due diligence will examine the management information systems, forecasting techniques, the assumptions on which financial projections are made, the latest available management accounts, including the company's cash and debtor positions, bank facilities, leasing agreements, pension funding, employee contracts, etc.

6.3.4 Final negotiations

If this in-depth analysis of the company proves satisfactory, you will embark upon the last stage: negotiating the final terms and conditions. This is when the transaction is legally secured.

The legal and financial framework will be finalised based on the preliminary agreements reached during the preceding stage of negotiations. The investment managers will propose different types of shareholdings. Equity-based compensation plans generally make up a significant portion of the rewards available to the entrepreneur and his team. But the investor will impose a period known as "vesting". This requires the stock option beneficiaries to stay in the company for a minimum amount of time before they can benefit from the preferential conditions of the stock options.

The investment manager may finance part of the investment with convertible bonds, allowing him a certain amount of remuneration during initial development, which he can convert back to equity in the next phase of the company's life. Similarly, if the company does not achieve certain objectives laid down in the development plan, the management team could lose certain subscription rights. These clauses allow the investors to be sure that their interests are aligned with those of the management team they have invested in.

The investment managers may insert anti-dilution clauses giving them a right of first refusal over any future issue of equity to outside investors. They may also have a veto on any stock-split operation that could dilute their investment.

The final price is determined using the valuation calculated during the first phase of negotiations, with any adjustments made in the event of new or unforeseen elements arising during the due diligence process.

You will now formalise your own personal equity stake and that of your team. In doing so, you need to determine the following:

- the value of the company;
- how earnings are divided;
- how the company is managed;
- future relations between shareholders;
- the investor's exit strategy.

The lawyers will draw up the acquisition documents. They will finalise the contracts that will organise your future relations, and draw up the final legal acts: the shareholders' agreement detailing the rights and obligations of each party (e.g. a reciprocal right of veto over certain decisions, transfer of preferential shares, the policy in place for distributing dividends, the composition of the Board of Directors, timetable for business and financial reporting), the investment protocol (the price and number of shares), changes required to the statutes, warranty letters, employment contracts for the management team, arbitration procedures, etc.

Investment bankers, lending banks and mezzanine funds will prepare the technical documents relating to the transaction.

At this stage, you should also employ the services of a legal and tax advisor (see below).

6.3.5. Signing the agreement

This is the stage at which you, the financial investors and the management team sign up to the capital increase and the lenders make the funds available. In addition, this is the stage at which the target company – in the case of a buyout – is acquired by the holding company.

The amount of time required to sign off a transaction remains a controversial subject. There is no general rule but considering the different stages before the formal agreement is reached and the funds are released, a period of four to six months is normal.

The figure on the next page summarises the different steps in the private equity investment process.

Figure 2: Different steps in the private equity investment process

STAGE	ENTREPRENEUR	ENTREPRENEUR & PRIVATE EQUITY FIRM	PRIVATE EQUITY FIRM	REPORTS
Approaching the private equity firm/evaluating the business plan	• Appoint advisors • Prepare business plan • Contact private equity firms		• Review business plan	• Business plan
Initial enquiries and negotiation	• Provide additional information	• Meet to discuss business plan • Build relationship • Negotiate outline terms	• Conduct initial enquiries • Value the business • Consider financing structure	• Offer letter
Due diligence		• Liaise with accountants • Liaise with other external consultants	• Initiate external due diligence	• Consultants reports • Accountants reports
Final negotiation and completion	• Disclose all relevant business information	• Negotiate final terms • Document constitution and voting rights	• Draw up completion documentation	• Disclosure letter • Warranties and indemnities • Memorandum and articles of association • Shareholders agreement
Monitoring	• Provide periodic management accounts • Communicate regularly with investor/s		• Seat on Board? • Monitor investment • Constructive input • Involvement in major decisions	• Management accounts • Minutes of Board and other meetings
EXIT				

Source: "A guide to Private equity", BVCA/PWC, June 2003

6.4. Advisors

6.4.1. The role of advisors

Your professional advisors (accountants, legal and tax experts, notaries and bankers) can introduce you to investors. They can help you to achieve the best results when looking for investors and can play an important role in the investment phase as well.

These same advisors will also help you when the investor exits the investment, regardless of whether you are leaving as well.

a. Accountants

Your accountant is often your first point of contact and will be with you for the whole process of preparing your business plan. He will analyse your business plan with a critical eye and will refocus it around the essential elements. He will check the accuracy of the financial projections and will be a key point of contact for the investor or the investor's auditors during the due diligence process.

He will pay particular attention to the warranties concerning your assets and liabilities that the investor may ask for. He will also have a role to play when negotiating loans with banks and valuing the company's shares.

b. Legal and tax advisors

They will carry out the legal planning of the operation and make sure the fiscal side of the operation is optimised, both at the time the investor joins the company and when you both exit.

Your lawyer will examine the offer letter and will help you to negotiate its conditions. He will negotiate the shareholders' agreement and the final documents, taking care that the warranties and obligations contained in these documents are limited only to the elements not previously divulged to the investor.

He will also draw up the company's statutes if a new company needs to be created. If the company already exists, he will make the necessary changes to the existing statutes.

6.4.2. Costs

Your company will bear the costs and fees demanded by those professional advisors. Therefore, you should make sure you ask in advance the cost of every task you commission and control how it is carried out.

Equally, the costs of the detailed audit carried out in the due diligence process may also be charged to your company. Generally, the investor will increase the amount of his investment to cover these fees. This solution has the advantage of not impacting on the company's cash reserves but it does increase the equity stake held by the investor.

Finally, you should reach a firm agreement about sharing the costs should negotiations break down. Usually in this case, each party bears the cost of the work they have commissioned.

7. Following up the Investment - Relations with the Financial Investor

One of the characteristic elements of the private equity business model is that the money invested does not belong to the fund managers but to the institutional investors (pension funds, insurance companies, banks), with the funds coming from the savings or investments of their own clients. Private equity firms are in fact intermediaries between capital providers and companies in need of capital.

Accepting funds from an external investor often results in profound changes to your company. If you allow a third party a stake in your equity, you must be ready for them to take part in strategic discussions and to be transparent in your decision-making procedures. The shareholders' agreement will play a full role in this, by establishing the principle of joint decisions and by balancing the interests of the shareholders (in particular through the use of stock options). Investors will help you to create or develop the value of your business by engaging themselves in the follow-up process.

7.1. The common aim of entrepreneurs and fund managers: balanced growth in a company

You will establish a permanent dialogue with the fund manager. The assistance given by the fund manager varies from case to case.

Contact between the investment manager, the entrepreneur and his management team will revolve around strategic discussions. The investment manager will bring all the experience he has accumulated from the other businesses in his portfolio. He is a "sounding board" and brings his co-operation and professionalism. His experience is useful when it comes to:

- organising subsequent rounds of investment;
- recruiting members of the management team;
- establishing financial reporting procedures;
- reacting to crisis situations;
- negotiating with the banks;
- negotiating the sale of the company to partners in the sector;
- finding additional shareholders.

In general, after an initially tentative period, you will find that this relationship is in your interest and results in detailed strategic thinking, a co-ordinated approach and a genuine dialogue.

The shareholders' agreement will cover the rights and duties of the fund manager, such as:

- to receive a regular performance scoreboard;
- to receive the minutes of Board meetings;
- to appoint a director to the Board, who may be an executive from the private equity firm or an external consultant;
- to be consulted (without intervening in management) on important decisions affecting the company (such as major investments, changes in strategic direction, business acquisitions and disposals);
- to veto certain decisions;
- to control the exit process.

This "right to information" is what the fund manager gets in return for the long-term engagement he has made in your company.

7.2. The different types of financial investors

a. Hands-on / hands-off approach

Certain investment managers are much more active in the investee company than others. This depends on the type of investment fund and how developed your business is.

Start-ups and some other special situations require the investor to operate very closely to the entrepreneur and his team. This active role is known as the “hands-on” approach. The investor will have built up a very useful network of professional contacts and will often have experience with similar companies to yours. This will compensate for the fact that your company has little or no performance history with which to gain the trust of bankers, clients or suppliers.

On the other hand, if the company is more developed, the investment manager will be dealing with a more experienced team. His stance will therefore be more “hands-off”. He will still expect to see steady development in the company, receive regular financial information and see that shareholders’ rights are respected.

In a debt-financed operation (a buyin/buyout), relations with the investor will be close and will be based on the experience of the management team, guided by the establishment of a rigorous and agreed financial reporting system. The relationship will allow the development of the cash flow to be closely monitored along with the ability of the company to provide dividends for its holding company.

Whether the investor is “hands-on” or “hands-off”, he is not involved in the day-to-day running of the company and places his trust in the company’s management team. He will only engage in day-to-day operations with the management team in the event of a serious crisis.

b. Their place and role on various committees and boards

Most investment managers will expect to be present or represented on the Board or the supervisory board. Their participation allows the company to benefit from the experience of a more active board member or member of the supervisory board. For the investor, this enables him to gain privileged access to information about how the business is performing.

Like all board members, they are subject to the same standards of corporate governance that apply to all unquoted companies. Financial board members are also subject to their own professional Codes of Conduct which govern, in particular, the event of a conflict of interest between two or more investments.

They will also take an active part in important committees such as the audit committee, the investment committee and the remuneration committee.

c. Investors’ liability

As board members, they have a considerable duty of care to other shareholders and creditors. Given their special financial background, they should help you to detect any signs of crisis: a sharp rise in fixed costs, deals agreed at non-revisable prices, a deterioration in credit control, an uncontrolled expansion in investments, high staff turnover, etc.

They will be very careful to avoid any risk of becoming too involved in the day-to-day operation of the company as this can destabilise their position and make them primarily liable in the event of an eventual company collapse.

8. The Investor's Exit and the End of the Investment Relationship

Exits are at the heart of private equity business. Planning an exit route is an integral part of the initial decision to invest. It should not be interpreted as a lack of interest in the company nor as a sign that the investment was only motivated by the desire for short-term profits. The goal of the investor is to help create or develop a business that will allow him to dispose easily of part of his equity stake.

After several years, the investment manager will want to exit the investment so that he can reimburse his own investors and cope with the limited time frame of the investment fund. Typically, the interval between investment and exit is three to five years.

Exit strategies differ depending on the size of the company, the sector in which the company operates and the stage of the company's development. The experience of the investment manager and his network of contacts will help him to achieve the best possible exit for him and his own shareholders as well as for the other shareholders in the company, first among which are you and your team.

8.1. Exit routes

There are different ways in which a private equity investor can exit from an investment:

a. Trade sale

A trade sale, also referred to as M&A (Mergers & Acquisitions), of privately held company equity is the most popular type of exit strategy and refers to the sale of company shares to industrial investors. Large and small companies often complement each other and an alliance between them allows one of them to secure a strategic advantage or complete its own business activities. A buyer is therefore often willing to pay a premium to acquire a complementary business.

The trade sale is agreed in private and makes both the buyer and the seller less vulnerable to the external pressures of a stock market flotation. It is often advisable to keep the transaction a closely guarded secret because clients, suppliers and employees may interpret a trade sale negatively. These negative signals become even stronger if the negotiations fail.

An "auction sale" is the one exception to this secrecy rule. When the seller's reputation is not at stake and if the operation is guaranteed to succeed because the company is very well positioned, an auction may be organised by specialist investment bankers. Potential buyers are subject to strict procedures and timings to ensure genuine competition between them. At the end of the process, the highest bidder wins. In this way, the price is maximised and the time taken to complete the sale is minimised.

In Europe, divestment through trade sale was the largest exit route by amount (22.7%) in 2006 at €7.5 billion (25).

(25) Source: EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity.

b. Entrepreneur or management team repurchase

The repurchase of a company by its management team is becoming more and more successful as an exit strategy. It is a very attractive exit for both the investment manager and the company's management team if the company can guarantee regular cash flows and can mobilise sufficient loans. The accounting and fiscal aspects of this exit need to be studied very carefully.

c. Sale of the investment to another financial purchaser (called a secondary market investor)

One financial investor may sell his equity stake to another one when the company has reached the stage of development initially envisaged or when the current development of the company no longer corresponds to the investment criteria of the original fund. This can also occur if the financial support required to maintain the company's development has exceeded the capacity of the fund. Equally, the fund itself could be winding up and may need to dispose of its final investment to satisfy its investors and to adhere to its own terms and regulations.

This strategy has the advantage of enabling an exit when the team does not want a trade sale or a stock market flotation.

d. IPO (initial public offering): flotation on a public stock market

A stock market flotation may be the most spectacular exit, but it is far from being the most widely used, even in stock market booms.

Is your business ready for a stock market flotation? To answer this you need to ask a number of questions about your business. Is it big enough to fulfil the required criteria, even on local stock exchanges? Is your business activity in a favourable sector? Do you have a "performance history" to present? And, above all, are you ready to face considerable changes in the culture and management of your company?

A stock market flotation should correspond with a genuine wish to make the company more dynamic over the long term and to profit from the growth possibilities offered by a stock market. Therefore, the equity share placed on the market (the float) must be sufficiently large to ensure liquidity – the reward for appealing to the market. A flotation is not an end in itself but the beginning of a long process of development.

It is true that there are a number of positive effects:

- access to finance for growth and acquisitions;
- ability to retain or attract quality staff via share incentive schemes (stock options);
- enhanced credibility and visibility with clients, suppliers and partners;
- possibility to pay for acquisitions with stock rather than cash;
- realisation of some of the shareholders' capital;
- possibility for financial investors to exit.

But these positive factors should not mask the challenges that a stock market flotation can create. Once listed, your business will be more visible and therefore receive increased scrutiny from the media and from financial analysts. Once a company is public, its head also needs to make himself much more available.

The costs of a flotation are high (estimated at 10% to 12% of the amount offered on the market). These are not only incurred when preparing for the flotation (three to five points) and paying for admission to the market (seven to ten points), but also recur annually due to the requirement of publishing and divulging information: relations with investors, financial communication, fees paid to lawyers and advisors to ensure that the financial information is managed strictly.

A stock market flotation always leaves you open to the risk of an unwanted bid whereas equity held by an investor that you have chosen can be better managed.

If you do decide to opt for this route, it must be minutely prepared over a long period:

- a clear development plan must be established;
- a high-performance management team must be in place;
- effective board members must be recruited;
- an audit committee must be established;
- accounting and financial documents must be drawn up in accordance with the standards required of quoted companies.

The preparatory period is very time consuming and the company must have a quality middle management team to allow the senior managers to devote their time to the flotation.

Finally, you should be aware that current market regulations forbid financial investors and entrepreneurs to dispose of their complete equity stake at the moment of the flotation. They are subject to a “lock-up” period during which they may only dispose of a small part of their equity stake. This period usually lasts six months on European markets.

e. Liquidation

This is obviously the least favourable option and occurs when the efforts of the head of the company and the investors to save the company have not succeeded.

8.2. Valuing the investment on exit

As with the investors’ entry into the company, the valuations undertaken during a partial or total exit will vary depending on the type of operation, the number of shares disposed of, the sector involved and the characteristics of the company. Reference will often be made to the valuation carried out at the time of the initial investment and your advisors will again be involved in the process.

9. An Organised and Specific Profession

9.1. The role of EVCA and the National Private Equity and Venture Capital Associations (NVCAs)

The European Private Equity and Venture Capital Association (EVCA) was established in 1983 and is based in Brussels. EVCA represents the European private equity sector and promotes the asset class both within Europe and throughout the world.

With 1,200 members in Europe, EVCA's role includes representing the interests of the industry to regulators and standard setters; developing professional standards; providing industry research; professional development and forums, facilitating interaction between its members and key industry participants including institutional investors, entrepreneurs, policymakers and academics.

EVCA's activities cover the whole range of private equity: venture capital (from seed and start-up to development capital), buyouts and buyins.

In association with its members and by means of several committees and working groups, EVCA organises the self-regulation of the profession by publishing guides about methods of valuing companies in its members' portfolios, governance rules and codes of good conduct. These are topics that directly concern investment funds when they are dealing with entrepreneurs.

Like all professional associations, EVCA sets up training sessions to allow its members to be kept permanently abreast of developments in the profession.

EVCA encourages research and analysis of the entrepreneurial environment in Europe and fosters the promotion of this environment.

Many countries also have a National Private Equity and Venture Capital Association, with the same aims as EVCA, but closer to the national environment. They can inform you about their members' areas of activity and publish an annual directory of their members, setting out their individual characteristics. This will help you find an investor suited to your project.

9.2. Professional standards

One of the goals of the European private equity sector is to provide great transparency to its investors and adequate disclosure to broader stakeholders. As the industry has matured, there has generally been perceived to be a need for greater consistency of valuation and reporting standards by managers of, and investors in private equity funds.

For nearly three decades, EVCA has worked to develop a full set of self-regulatory professional standards and guidelines for the industry.

These standards [26] include International Private Equity Valuation Guidelines, Reporting Guidelines and a full set of corporate governance guidelines to govern the relationship between the private equity fund managers and the underlying portfolio companies in which they invest. The industry is also working to replace its current Code of Conduct with a Code of Ethics. This new Code of Ethics will be compulsory for EVCA full members, who represent over 80% of the private equity and venture capital under management in Europe.

[26] For further information on professional standards, please visit: http://www.evca.eu/html/PE_industry/IS.asp

10. Conclusion

The European private equity market has seen spectacular growth over the past few years as an increasing number of entrepreneurs have decided to drive their company's growth forward by seeking the finance, experience, expertise and advice available from private equity investors. However, there are many more companies in Europe that could harness those same resources that the private equity sector offers to help drive them towards higher growth.

We hope that this guide has been able to provide you with an overview of how private equity works in practice and what you need to do to improve your chances of getting access to it, encouraging you to approach a source of private equity early in your search for finance and dispelling any mystery and doubts that still surround it.

Moreover, we hope that we have demonstrated the positive advantages that private equity will bring to your business.

Have we succeeded? If so, then prepare your business plan, find a private equity investor and accelerate the growth of your business.

11. Useful links

A full glossary is at your disposal at:
http://www.evca.eu/html/PE_industry/glossary.asp

For other useful links, see:
http://www.evca.eu/html/PE_industry/info_home.asp

For additional information on any of the issues mentioned in this guide, please contact:

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