



# A Quick Guide to Equity Investment in Private Companies

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## What we will Cover.....

- Venture Capital vs Private Equity
- Some Common Terms
- What is Debt Gearing
- Geared Equity
- Options, Convertibles and Issued Share Capital
- Capitalisation Tables
- The Investment Agreement and The Articles
- Investor Protection Terms
- Warranties
- The Illusion of Ownership vs Control

## Venture Capital / Private Equity – the difference

	Venture Capital	Private Equity
Risk Profile	Early stage with no financial track record	Established business with visible cash flows
Returns	Seeking money multiples of 5x +	Money multiples of 2-4x
Financing	High risk equity	Drive returns from gearing
Types of Transaction	Start-up and development	MBOs and Acquisitions
Ownership	Usually minority unless syndicated	Often majority ownership
Investment Strategy	Frequently multiple rounds	Clear exit agenda in 2-4 yrs

## Venture Capital / Private Equity – the similarities

- The need for value growth
  - What is value
  - Value vs Cash Flow
  - Identify the exit
- Management focus
  - Who will create value
  - Does management have the skills
- Influence / Control
  - Consent Rights
  - Board Representation

## Some Common Terms - 1

- Share Value
  - the value attaching to a particular share
- Equity Value
  - the value attaching to the equity share capital
  - this is the number of shares multiplied by share value
- Enterprise Value
  - the business value free of any financing structure
  - frequently used in PE/VC
  - a focus for public company analysts
  - value is share value added to debt (less free cash)
- Gearing
  - the level of debt used to fund a business or asset
- P/E ratio
  - the multiple by which value exceeds earnings
  - match right value to earnings line

## Some Common Terms - 2

- IRR (Internal Rate of Return)
  - the discount rate that equates the net present value of all cash flows from a particular project equal to zero
- Money Multiple
  - cash returns expressed as a multiple of cash invested
- Pre-money value
  - the equity value immediately prior to a further investment round
- Post-money value
  - the equity value immediately after an investment round
  - post-money value is essentially pre-money value plus the amount invested
- Dilution
  - the reduction in ownership for existing shareholders as a result of a further investment round
  - dilution is expressed as a percentage and is essentially the amount invested divided by the post-money value

## What is Debt Gearing

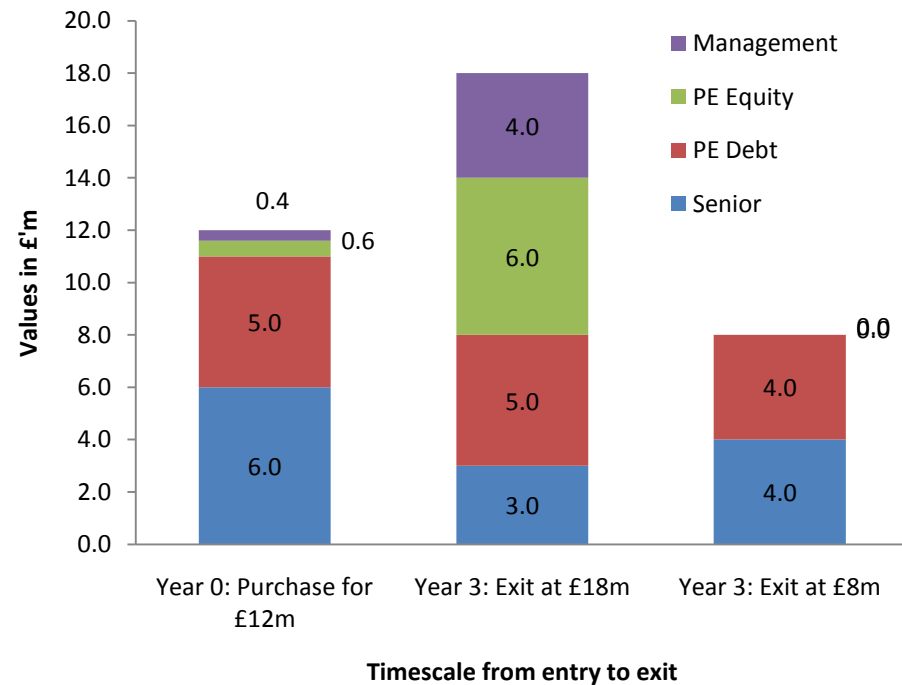
- Gearing is the use of debt to finance an asset to enhance equity returns
- Over gearing can increase the risk of equity returns
- Key differences between debt and equity

	Debt	Equity
Risk Profile	Low risk	High Risk
Returns	Fixed contractual interest	Dependent on value growth and de-gearing
Income	Interest	Dividends
Repayment	Contracted	Sale of the business
Security	Secured on assets	None
Control/Influence	Covenant and loan terms	Share ownership

# How Gearing Works- A Worked Example

	Year 0: Purchase for £12m	Year 3: Exit at £18m	Year 3: Exit at £8m
EBIT £'m	<u>3</u>	<u>4.5</u>	<u>2</u>
EBIT Multiple	<u>4</u>	<u>4</u>	<u>4</u>
Enterprise Value £'m	<u>12</u>	<u>18</u>	<u>8</u>
Funded by:	£'m	£'m	£'m
Senior	6.0	3.0	4.0
PE Debt	5.0	5.0	4.0
PE Equity	0.6	6.0	0.0
Management	<u>0.4</u>	<u>4.0</u>	<u>0.0</u>
	<u>12.0</u>	<u>18.0</u>	<u>8.0</u>

## A Private Equity Transaction £'m



## How Gearing Works- For us All!

### A Personal Mortgage £'000



## Equity – no bank gearing

- a straight forward split in the ownership of the business



a straight forward split of the value!

- a worked example – we will invest £1m for 40% of the equity

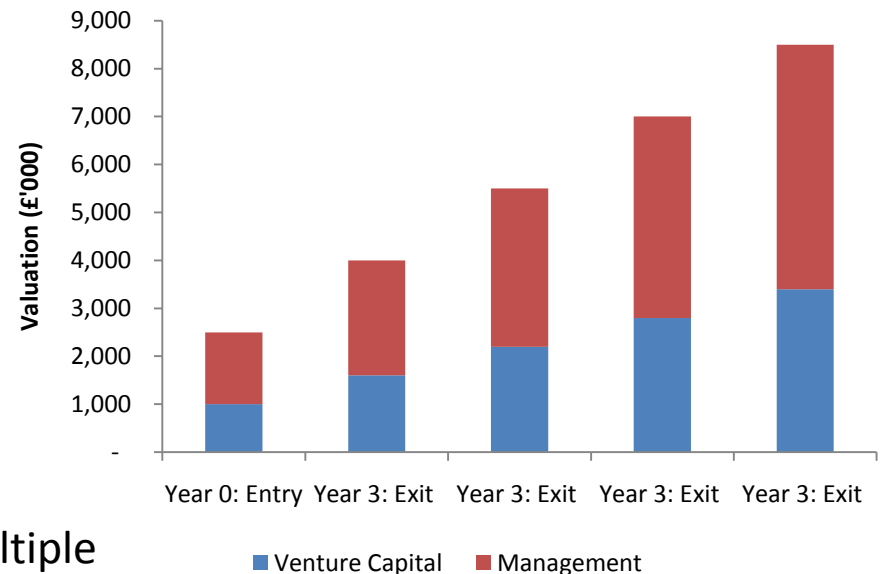
- what is the:

➤ post-money value? **£2.5m**

➤ pre-money value? **£1.5m**

- so at various exit values proceeds are split predictably
- a 3 year exit for £7m generates the VC proceeds of £2.8m, being a 41% IRR and 2.8 times money multiple

Ung geared Equity Proceeds Split



## Equity – ‘VC’ gearing

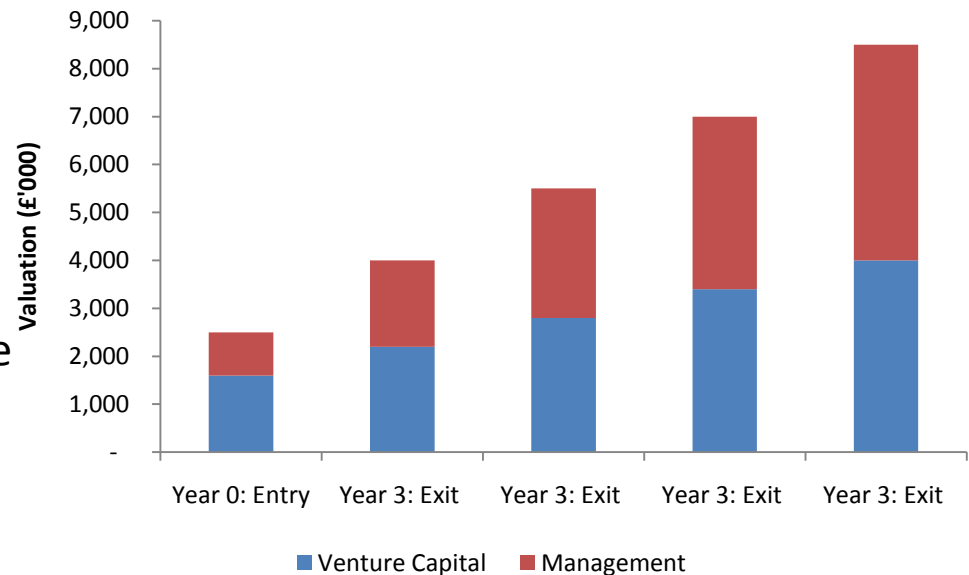
- So how do VCs ensure there the split in value is not straight forward?



Liquidation Preference

- A liquidation preference adds gearing to the VC returns without gearing the balance sheet to get a priority return
- A ‘1x’ preference ensures the return of the investment before equity proceeds are split according to relative ownership
- Same exit proceeds and same equity percentages gives a different split
- a 3 year exit for £7m generates the VC proceeds of £3.4m, being a 50% IRR and 3.4 times money multiple

Split of Exit Value With Liquidation Preference of 1

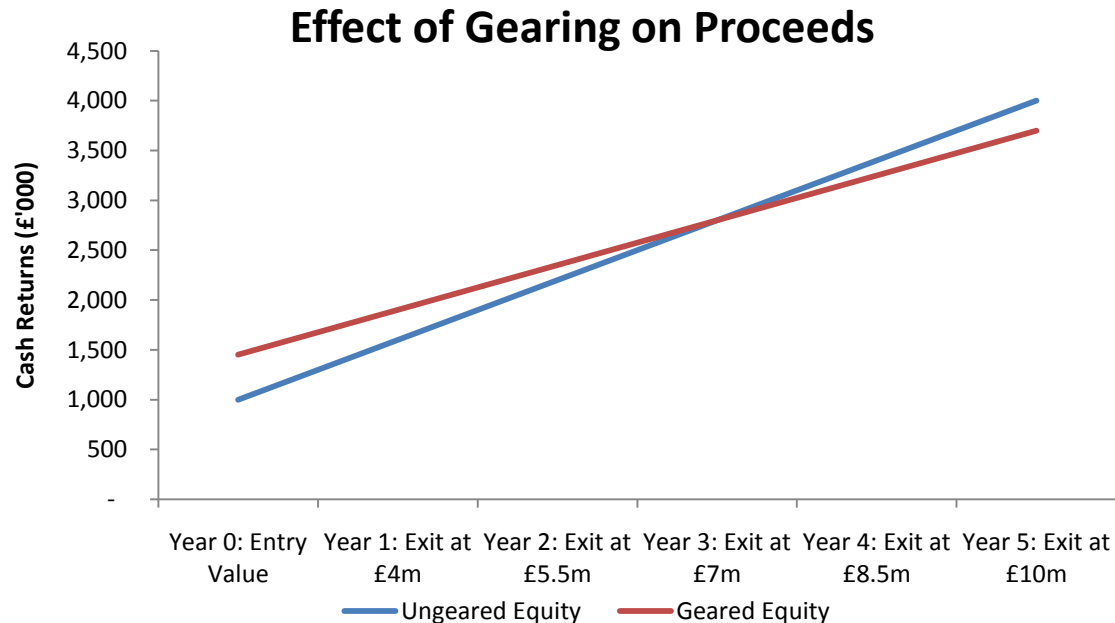


## Equity Gearing to Incentivise Management

- The use of a liquidation preference can change the split of proceeds
- Technique resisted by management as unfair
- Consider the same proposal of £1m for 40% (no preference) and compare to £1m for 30% with a liquidation preference of '1'
- What is post-money value? **£3.33m**
- What is the pre-money value? **£2.33m**
- More attractive for management?? **Maybe!**

## Equity Gearing to Incentivise Management

- The graph illustrates the proceeds to the VC at differing exit values



- At exit values below £7m the VC gets a higher share of proceeds
- In addition we can also have special dividend rights

## Options, Convertibles and Issued Share Capital

- Issued Share Capital is share capital
  - where share certificates are in issue
  - and holders of certificates have a right to vote and participate in the company profits at any moment in time

**This determines who exercises voting control**

- Options are shares allocated to a party who has a right to acquire them
  - Vesting periods and exit
  - Exercise terms
  - Put and call options
- Convertibles are loan or debt instruments (or warrants) that can be converted into issued shares
  - can be put or call conversion
  - conversion terms

**Exercise of all options and convertibles results in the  
FULLY DILUTED SHARE CAPITAL**

## Back to OUR VC Deal.....

- Assume existing management team have 15,000 shares and 5,000 shares under option
- Again we will invest £1m for 40%
- How does this move the capitalisation table and the relative voting

	Current Equity Ownership				New Equity Ownership			
	Shares		In Issue %	Fully Diluted %	Shares		In Issue %	Fully Diluted %
	In Issue No	Options No			In Issue No	Options No		
Harry	6,000	800	40.0%	34.0%	6,000	800	24.0%	22.7%
Fred	4,500	1,500	30.0%	30.0%	4,500	1,500	18.0%	20.0%
Tom	4,500	2,700	30.0%	36.0%	4,500	2,700	18.0%	24.0%
VC			0.0%	0.0%			0.0%	0.0%
			0.0%	0.0%	10,000	-	40.0%	33.3%
Totals	15,000	5,000	100.0%	100.0%	25,000	5,000	100.0%	100.0%

New Investment of £1m for 40%

Number of Shares Acquired 10,000

Price per share £ 100

## The Investment Agreement and The Articles

- The Investment Agreement
  - Sets out rights and obligations of shareholders as individuals. Not class rights
  - Is a contract setting out the terms on which the investment has been made
  - Will include investment conditions precedent and subsequent, warranties, information rights, investor consents, conduct of business
  - Private document
- The Articles
  - Public contract between the various classes of shareholder
  - Contains rights attaching to each class of share such as dividends, right to appoint directors, economic rights of classes of share
  - A standalone document
- The Investment Agreement will include a clause such that where they conflict the Investment Agreement prevails

## Investor Protection Terms

- Means of skewing the balance of rights away from relative voting or economic rights
- Investor rights are mostly 'negative' in that they require a consent for an action, some are positive in that they can force a matter
- Typical positive investor rights include
  - Drag along rights
  - Anti-dilution
  - Appointment of advisors for a sale or exit
  - Company's enforcement of warranties (usually in MBO)
- Typical negative rights relate to nature of business, appointment of directors/senior employees, changes to articles, winding up, share transfers, warranties
- Information rights
- The rights of ordinary minority shareholders under Companies Acts are very limited – accounts, AGM (?), resolutions (?)

## Warranties – The Benefits

- A warranty is a statement of a fact which the party giving the warranty ( the warrantor) asserts to be true
- Warranties generally relate to matters which cannot easily be verified by the other party. For example the business has
  - not infringed legislation (competition/employment/environmental)
  - no claims from employees
  - no product warranty claims
  - not breached any other parties IP rights
  - not breached a 3<sup>rd</sup> parties IP rights
- The legal purpose is no enable a beneficiary of a warranty to claim damages in order to put himself in the financial position he expected to be in reliance on the warranty
- Consider issues generated from due diligence
- The practical purpose is to engender disclosure against warranties

## Warranties - Qualification

- The nature of the warranty
  - an absolute warranty
  - qualified by awareness
    - ✓ knowledge of management
    - ✓ level of enquiry
  - advisors to vendor - what do they know?
  - time limits
  - financial limitations
  
- Disclosure Letter
  - Standard public databases (Companies House, Land Registry)
  - Specific disclosures
    - ✓ ensure they are clear and specific and referenced to the warranty in question
    - ✓ ensure they are precise in what is being disclosed
    - ✓ due diligence – ensure is specific
  - AVOID general disclosures eg ‘publically available information’ or ‘all correspondence between the parties’ or ‘the due diligence’

## The Illusion of Ownership vs Control

- If the shareholding is split 60%/40% for example - who is in control
- If the share ownership is split 60%/40% what are the relative economic interests
- Relative return is about the financial structure
- Control is about the investment agreement
- With a full suite of the usual terms in the articles and investment agreement look at the detail

**Thank You**

**QUESTIONS ?**

