FINDING THE RIGHT BACKING

JIM KEELING OF CORBETT KEELING EXPLORES THE ISSUES FACING BUSINESSES WHICH WANT TO GAIN ACCESS TO THE PRIVATE EQUITY CAPITAL MARKETS.

There are many considerations for businesses thinking of accessing the private equity markets, which we will explore in this article. But, first, companies will want to know: "Are funds really available through this route?" The answer is an emphatic "yes".

The market for private equity started to take off in the early 1980s, when the first three or four funds – including 3i and a fund to which our business is distantly related, Safeguard Industrial Investments – were joined by a number of new private equity fund managers. Some of these were unsuccessful and failed to raise further funds to invest. But many others achieved remarkable success and have since raised new funds on numerous occasions – in some cases, in the last year or so. As a result, plenty of private equity funds have large amounts of money that they are looking to invest at the moment – all they need is good opportunities to back.

PRICE EXPECTATIONS. Another question firms will want to ask is: "Can our price expectations meet those of the funders?" Again, the answer is "yes". With tumbling stockmarkets and the bursting of the technology bubble, the expectations of those of us involved in selling equity have dropped dramatically in the past year or so. This leaves plenty of scope for sellers and buyers of equity to agree on valuation. Cannier buyers know that the next 18 months to two years represent a great opportunity to make investments.

On to the next issue: "Will the return the investors demand be so extortionate that I am put off by this alone?" This one is harder to answer. Yes, the returns are high – typically 30% a year for a buyout-type transaction. But firms must consider the following:

- given the risk of losing all your money (something that happens quite often), it is not unreasonable for the investor to aim for this sort of return;
- if your transaction is partly funded by debt, the average return to all capital providers will be a lot lower; and
- if you are raising equity capital, you will, by definition, have a business plan that entails high growth. Therefore, the returns demanded will not necessarily entail your giving up an unacceptable percentage of your equity.

How can you access the private equity market?

The first step is to ask yourself a very basic question: "Should I take the DIY route or get professional help?" Many people assume they can simply walk into a private equity provider and walk out with a cheque. Unfortunately, that is not how it works.

The process of raising funds usually takes three to six months and, throughout, careful preparation, planning and execution are crucial to achieving the best deal for you, the beneficiary of the funds raised. Finding an adviser which deals with these sorts of transactions regularly and knows the market for raising funds inside out is vital.

The steps you will need to go through are as follows:

- Establish with your adviser that your proposition is good enough to attract funding (see the 'Who can use the private equity market?' box).
- Adjust your plan so that you achieve the best possible result when you meet funders – for example, it may be better to raise more or less funds, or you may need to add someone to your management team to make your proposition more attractive.
- Decide what sort of funders you will approach: those who favour buyouts, or those who like earlier-stage businesses, private or institutional funds and the like. The tastes of investors are generally very specific.
- Decide on the likely structure of the funding, for example, the split between debt and equity, and – a key ingredient – the amount of money the management team can put up.
- From the chosen type of funders, select those that you >>

<< think are most likely to back your plan and approach them, present to them and agree provisional terms – preferably with two or three so you can compare their offers and negotiate an appropriate deal.

- Agree a due diligence process that can be executed as fast as possible with the chosen source of funds.
- Agree all the legal documentation for the transaction, such as contracts for funding and buying assets.
- Close the deal and start the real work of executing your plan.

Who can use the private equity market?

The answer is simple: anyone who has a good enough business proposition. The trick is to come with a really good one because the better it is, the more funders you will attract.

Equity funding can be used to:

- buy a business – for example, a 'management buyout' or 'buy-in';
- enable one shareholder to sell shares while another retains theirs – a 'partial exit';
- develop a business, for example, to expand into new markets or products – 'development capital';
- rescue a business – often, if a business has run into difficulties it can be turned around, but the missing ingredient is cash – 'turnaround capital'; and
- start a business – this is true 'venture capital'.

The amount of cash required might be any sum from a £100 to £100m. Incidentally, there is in our view no such thing as an 'equity gap' at the lower end of this range.

What does exist is a far higher proportion of bad business propositions seeking smaller amounts of funding. Naturally, the bad propositions do not get funded. It is this that leads to the perception of a 'gap'. By contrast, whatever the cash requirement, good business propositions will attract funds. In addition, the private equity markets are not open just to private companies but also to public-listed companies.

Nowadays, some funds will make minority investments directly into listed companies, as well as considering the better known 'take private' transaction, in which they buy the entire listed business.

So, no, you may ultimately not be put off by the returns demanded. If you still feel that institutional providers of equity are too greedy, be assured that, in our experience, successful private investors look for similar returns to those demanded by their institutional counterparts.

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KEEPING CONTROL? The next question for companies is: "Are we going to lose control of the business?" Raising private equity is a form of partnership: in effect, the providers of money become your new partners. However, those new partners will not usually be expert in your field, so the degree to which they can interfere is limited.

More importantly, your backer will have invested because they think the management team running the business is excellent. So the last thing they would normally do is over-rule or veto a course of action management proposes to take. They will expect management's ideas to be good and their starting point will be to back them.

Of course, if the first two or three projects executed by management fail, they will begin to question whether the team they backed is really as clever as they had imagined. Then the partnership will begin to operate differently, with the investor taking a closer interest in the detailed running of the business and expecting decisions to be taken jointly. If things continue to go wrong, and a disagreement arises between the management and its backers, each party will have to look to the investment and related agreements to see who calls the shots. However, that is a worst-case scenario and not how things should turn out if you demonstrate the skills that attracted your backers in the first place.

FINDING FUNDING. The final key factor is finding the right backer. We have a simple view of the value of businesses. We rate them on a scale, with a maximum of 1 and a minimum of 0, the value being calculated by multiplying the quality of management by the quality of business and the quality of ownership – all three of which also have a value of between 1 and 0.

The point is that you can have a brilliant management team (scoring 1) and a brilliant business with great products and markets (also scoring 1). But if the ownership scores 0, for example, because it is always arguing among itself, then the business can easily lose all its value: $1 \times 1 \times 0 = 0$. So in our view it is crucial not just to find backers but to find the right ones.

KEYS TO SUCCESS. There are a number of crucial issues facing businesses which access the private equity markets. Each can have a very material impact – favourable or adverse – on the outcome of the transaction envisaged. The most careful planning, preparation and execution, with all the associated specialist advice, are the key ingredients of a successful fund-raising.

Jim Keeling founded Corbett Keeling Limited, the London-based corporate finance house which advises businesses on raising equity funding in the bracket £0.5m to £20m.
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