PRIVATE EQUITY: ITS PLACE IN CORPORATE FINANCE AND HOW IT WORKS

Chris Hale, Chair Emeritus, Travers Smith LLP

February 2020
Contents

- What is private equity?
- The geography of private equity
- The importance of private equity
- The success of private equity – and why
- How private equity works – at the fund level
- How private equity works – at the deal level
- Current trends and final thoughts
Private equity: What is it?

Private equity is risk capital provided in a wide variety of situations, ranging from finance provided to business start-ups to the purchase of large, mature quoted companies, and everything in between.

Key elements of private equity are:

- Investment in unquoted companies
- Equity capital by nature
- Medium to long term
- Targeted at companies with growth potential
Geography of Private Equity: Where is the capital being invested

- **Rest of the world**
- **Asia**
- **Europe**
- **North America**

**Value in billion U.S. dollars**

Year | Value (billion U.S. dollars)
--- | ---
2015 | 250
2016 | 200
2017 | 175
Private equity: How important is it economically?

Many household names have been previously backed by private equity...

... and many household names are currently owned by private equity.

The private equity ownership model can be applied to a wide range of company types, sizes, sectors and geographies: from very small domestically-orientated companies to large multinationals.
Private equity: How important is private equity economically?

- According to IE Consulting in 2007 companies in the UK that have received private equity backing accounted for the employment of 3 million people in the UK, amounting to 21% of the UK private sector workforce.
- IE Consulting also said that in 2007 private equity backed companies in the UK generated total sales of £310 billion and contributed more than £35 billion in taxes.
- The portfolio companies taken together of each of Carlyle, KKR, Blackstone and Apollo rank among the 10 largest employers in the US.
- According to Bain in 2013 private equity backed companies accounted for 23% of the US’s mid-sized companies and 11% of its large companies.
- What are the consequences of all this for labour productivity, compensation per worker and employment?
Private equity: How important is it to M&A?

- Globally in 2019 buy-outs accounted in value terms for about $400 billion out of $4 trillion money spent (2018 $580 billion and $4.1 trillion).
  
  Source: Wachtell Lipton

- BUT in the UK in the first 9 months of 2019 buy-outs accounted for 64 per cent of total M&A value. This figure is not unusual in the last 10 years.

  Source: CMBOR
How has private equity grown?

See hand out
Why has private equity been successful?
There are 3 main ways in which private equity creates value

- **Profit growth**
  - Revenue growth:
    - Organic - new investment, market fundamentals, geographic or product extensions etc.
    - Inorganic - Acquisitions
  - Margin improvement

- **Leverage**
  - Bank debt comprised 60-70% of deal funding pre credit crunch dropping to 40-50% in the credit crunch but now approaching pre-crisis levels again

- **Entry versus exit multiple**
  - Market position / defensibility
  - Margins / cash generation
  - Market timing etc.

* Returns from PE relative to the stock markets*
Entry EV range, 2005 - 2011

* Source: EY*
Private Equity vs Public Companies

- Universe of listed companies in UK and US shrinking dramatically.

- Why?

- But size of remaining listed companies increasing.

- Will this trend continue?
How does private equity work?
At the house or fund level
What is a private equity house?

- Most are independent raising funds from outside investors and whose money they manage, the fund typically being structured as a limited partnership.

- Some are listed companies, such as 3i, investing balance sheet money.

- Funds will have a limited life, as we will explain, will be illiquid and will not have borrowings.
Who invests in Private Equity?
Main investors in Private Equity include pension funds and insurance companies

- Largely institutions such as pension funds and insurance companies
- In the UK, investors are mainly from overseas (over 70%), particularly the US
- European public and private pension schemes allocate around 4% to the asset class. This lags behind US allocations of around 6.5% and Australasian allocations of just over 5%*
- Allocations to the asset class from family offices and sovereign wealth funds reached 10% and 18% respectively*
- An example:

**Investors by geography in Bridgepoint funds**

- Asia
- UK
- Rest of Europe
- Middle East
- North America

**Investors by type in Bridgepoint funds**

- Sovereign entities
- Asset manager
- Bank
- Corporate pension funds
- Endowment foundations
- Fund of funds
- Insurance companies
- Public pension funds

*London Business School Coller Institute of Private Equity*
<table>
<thead>
<tr>
<th>Region</th>
<th>No. of Investors</th>
<th>Current Allocation</th>
<th>Target Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>1,954</td>
<td>55%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Asia</td>
<td>1,207</td>
<td>25%</td>
<td>10%</td>
</tr>
<tr>
<td>Rest of World</td>
<td>656</td>
<td>10%</td>
<td>7.0%</td>
</tr>
<tr>
<td>North America</td>
<td>3,874</td>
<td>24%</td>
<td>25%</td>
</tr>
<tr>
<td>Latin America</td>
<td>184</td>
<td>4.2%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Nordic</td>
<td>239</td>
<td>4.1%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Central &amp; Eastern Europe</td>
<td>71</td>
<td>4.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Middle East &amp; Israel</td>
<td>186</td>
<td>2.5%</td>
<td>10.0%</td>
</tr>
<tr>
<td>China</td>
<td>430</td>
<td>2.5%</td>
<td>20.0%</td>
</tr>
<tr>
<td>Japan</td>
<td>239</td>
<td>2.6%</td>
<td>5.0%</td>
</tr>
<tr>
<td>South Korea</td>
<td>132</td>
<td>5.0%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Singapore</td>
<td>87</td>
<td>11.0%</td>
<td>17.5%</td>
</tr>
<tr>
<td>Australasia</td>
<td>158</td>
<td>3.5%</td>
<td>6.0%</td>
</tr>
</tbody>
</table>

Source: Preqin Global Private Equity and Venture Capital Report 2019

Fig. 4.1: Proportion of Aggregate Capital Invested in Private Equity by Investor Location, 2014 vs. 2018

*Excluding the UK
How does a limited life fund work?
Lifecycles of Private Equity Funds typically last 10 years

1. Fundraising
2. Sourcing
3. Due Diligence
4. Deal structuring and execution
5. Operational support and value creation
6. Exit and returns

Private equity investors can take a more patient, longer-term approach to investing. In contrast, publicly-listed companies may be subject to the pressures associated with stock market fluctuations and quarterly reporting, which may compromise a focus on longer-term opportunities and returns.
What returns does private equity target?

- In buy-outs, a c. 20-25% IRR and a cash-on-cash money multiple of 2-3x +

- In venture capital and some buy-outs which are seen as riskier, the target returns will be higher

- Funds have different target returns and different variances in their returns

- Average hold period 4 years for buy-outs – but these increased dramatically during the economic downturn
How are private equity fund managers remunerated?

- Management fees – usually 1.5% to 2% per annum

- Carry, i.e. participation in performance of fund above a certain level

- Co-invest, i.e. executives of private equity houses can invest in-house deals

- Current trends – the importance of co-investment, deal by deal structures
How does private equity work?
At the deal level
How Private Equity Works: A Typical Buyout Structure

MANAGERS

SELLERS

TARGET

NEWCO 1

NEWCO 2

NEWCO 3

DEBT PROVIDERS

INVESTOR

money

money

loan notes

money

shares, warranties and covenants

warranties, covenants and security

warranties, covenants and security

money

purchase price

shares

shares

money

Shares, warranties and covenants

day-to-day control

Money

Loan or share subscription

Money
Management is both incentivised by, and subordinated to, shareholder return.

Sweet equity grows faster, but is subordinated to institutional equity.

Institutional equity grows slower.

Debt paid down.

Note: Values are illustrative only.
Private Equity and its affect on M&A

- Changed the dynamics. The sell side came to dominate.

- Professionalisation and development of sophisticated due diligence.

- Management became significant players in the process.
There are many participants involved in Leveraged Buy-Outs

Participants in a leveraged buy-out

Advisors – several hundred people can be involved in a single transaction:

- Corporate finance advisers for buyer and seller
- Legal counsel for buyer, management, seller and banks
- Accountants for buyer and seller
- Tax experts
- Insurance experts
- Environmental experts
- Pension experts
- Property experts
- PR/communications for buyer and seller
- Etc.
Legal advisors play a key role in the deal structuring and execution phase

Key Documentation: Acquisition

- Sale and purchase agreement
- Sets out price – locked box vs completion accounts
- Warranties – what they are there to do
- UK vs US practice
Legal advisors play a key role in the deal structuring and execution phase

Key Documentation: Equity

- Shareholders’ or Investment Agreement
  - Subscription
  - Warranties and restrictive covenants
  - Governance architecture
  - Exit provisions

- Articles of Association
  - Classes of capital (voting, income, redemption, conversion, rights on liquidation)
  - Share transfers
  - Leaver provisions
  - Tag and drag rights
Legal advisors play a key role in the deal structuring and execution phase

Key Debt Documentation: Debt

- Senior Debt evidenced by Facilities Agreement
  - mechanics for drawdown, repayment and payment of interest warranties
  - covenants – restrictive, positive and financial
  - events of default – e.g. on non-payment, loan accelerates/on demand secured

- Mezzanine
  - follows senior
  - higher interest rate, higher fees
  - equity option (warrants) sometimes

- Unitranche

- DCM
Current Trends and Final Thoughts

- Private equity houses becoming multi-product asset managers
- Flight to quality
- Many others now following private equity strategies
- Rise of secondary market in LP interests