MASTERING PRIVATE EQUITY

Transformation via Venture Capital, Minority Investments & Buyouts

Claudia Zeisberger Michael Prahl Bowen White

Foreword by Henry Kravis, Co-Chairman and Co-CEO of KKR

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CONTENTS

List of Contributors		*vii*
Foreword by Henry R. Kravis, Co-Chairman and Co-CEO of KKR		*ix*
Preface		*xiii*
How to Use This Book		*xvii*
Section I	**Private Equity Overview**	**1**
Chapter 1	Private Equity Essentials	5
Chapter 2	Venture Capital	19
Chapter 3	Growth Equity	33
Chapter 4	Buyouts	43
Chapter 5	Alternative Strategies	57
Section II	**Doing Deals in PE**	**69**
Chapter 6	Deal Sourcing & Due Diligence	73
Chapter 7	Target Valuation	87
Chapter 8	Deal Pricing Dynamics	97
Chapter 9	Deal Structuring	109
Chapter 10	Transaction Documentation	121
Section III	**Managing PE Investments**	**133**
Chapter 11	Corporate Governance	137
Chapter 12	Securing Management Teams	149
Chapter 13	Operational Value Creation	161
Chapter 14	Responsible Investment	173
Chapter 15	Exit	185
Section IV	**Fund Management and the GP–LP Relationship**	**197**
Chapter 16	Fund Formation	201
Chapter 17	Fundraising	215
Chapter 18	LP Portfolio Management	227
Chapter 19	Performance Reporting	241
Chapter 20	Winding Down a Fund	253
Section V	**The Evolution of PE**	**263**
Chapter 21	LP Direct Investment	267
Chapter 22	Listed Private Equity	279
Chapter 23	Risk Management	289
Chapter 24	Private Equity Secondaries	301
Chapter 25	Evolution of Private Equity	313
Acknowledgments		*325*
About the Authors		*327*
Glossary		*329*
Index		*341*

LIST OF CONTRIBUTORS

Our distinguished Guest Authors made time to share their experiences and at times critical comments, thereby adding a practical perspective to our writing. We are grateful for their support and list them in order of appearance.

- *A Look Back at the Last 45 Years*
  T. Bondurant French, Executive Chairman, **Adams Street Partners** (page 15)
- *What Is a Venture Capitalist?*
  Brad Feld, Managing Director, **Foundry Group** (page 28)
- *Creating Value Through Genuine Partnerships*
  J. Frank Brown, Managing Director and Chief Operating Officer, **General Atlantic** (page 35)
- *A Differentiated Approach—Buying Right and Creating Value Early*
  Andrew Sillitoe, Co-CEO and a Partner in the Tech & Telco team, **APAX Partners LLP** (page 48)
- *Distressed Investing: Why Europe is Different from the US*
  Karim Khairallah, Managing Director, European Principal Group, **Oaktree Capital Management (UK) LLP** (page 61)
- *Hunting for Deals in Emerging Markets*
  Nicholas Bloy, Founding Partner, **Navis Capital Partners** (page 77)
- *The Due Diligence "Conspiracy"*
  Richard Foyston, Founding Partner, **Navis Capital Partners** (page 81)
- *Understanding Enterprise Value*
  Graham Oldroyd, Partner from 1990–2013, **Bridgepoint Private Equity** (page 92)
- *Deal Pricing Dynamics Outside the Financial Model*
  Veronica Eng, Retired Founding Partner, **Permira** (page 101)
- *The Art of Deal Structuring*
  Guy Hands, Chairman and Chief Investment Officer, **Terra Firma** (page 114)
- *Deal Documentation—"Clean Exit" vs. Purchaser Protection*
  Heiner Braun, Partner, **Freshfields Bruckhaus Deringer LLP** (page 125)
- *"Govern a family as you would cook a small fish—very gently": About growth capital investments in family-owned SMEs in emerging markets*
  Idsert Boersma and Martin Steindl, **FMO** (page 143)
- *What Makes a Great Private Equity CEO?*
  Tony DeNunzio CBE, Chairman of **Pets at Home** and formerly Chairman of **Maxeda BV** (page 156)
- *More than Private Equity-Skilled Industrialists*
  William L. Cornog, Member and Head of **KKR Capstone** (page 164)
- *Responsible Investing: In Growth Markets, It's Common Sense*
  Tom Speechley, Partner, **The Abraaj Group** (page 181)

- *The Proof is in the Exit*
  Marco De Benedetti, Managing Director and Co-Head of European Buyouts, **The Carlyle Group** (page 193)
- *Not on the Side*
  Andrew M. Ostrognai, Partner, **Debevoise & Plimpton LLP** (page 212)
- *Raising a First-time Fund*
  Javad Movsoumov, Managing Director, Head of APAC Private Funds Group, **UBS** (page 220)
- *Relative Value Approach to Enhance Portfolio Returns*
  Christoph Rubeli, Partner and Co-CEO, **Partners Group** (page 235)
- *Performance Reporting 2.0*
  Peter Freire, CEO, **Institutional Limited Partners Association (ILPA)** (page 245)
- *GP-led Liquidity Solutions*
  Francois Aguerre, Partner, Co-Head of Origination, **Coller Capital** (page 259)
- *CPPIB's Partnership Centric Approach to Private Equity Investing*
  Julie Gray, Senior Principal—Investment Partnerships (Funds, Secondaries and Co-Investments), **Canada Pension Plan Investment Board (CPPIB)** (page 275)
- *Listed Private Equity Funds: Is the Market Missing an Opportunity?*
  Emma Osborne, Head of Private Equity Fund Investments, **Intermediate Capital Group plc;** Mark Florman, Chairman, **LPEQ** (page 286)
- *FX: Hedge or Hope?*
  Rob Ryan, Market Risk Manager, **Baring Private Equity Asia** (page 297)
- *The Importance of the Discount to Maximize Return: Myth or Reality?*
  Daniel Dupont, Managing Director, **Northleaf Capital Partners** (page 304)

Henry R. Kravis, Co-Chairman & Co-CEO of **KKR** kindly agreed to write the foreword for this book and we appreciate his thoughtful contribution on the evolution of private equity over the years.

The views expressed in the guest comments are the opinion of the respective author and not necessarily that of their firms and organizations.

FOREWORD

Henry R. Kravis, Co-Chairman and Co-CEO of KKR

What is private equity? Given you're reading this book, I'm certain this is a question you'd like to have answered.

To define the asset class properly is not as simple as looking it up in a dictionary or conducting a quick search on the internet. To do so would give you some version of private equity is capital that is invested privately. Not on a public exchange. The capital typically comes from institutional or high-net worth investors who can contribute substantially and are able to withstand an average holding period of seven years.

But private equity is so much more than its literal definition.

The way I would describe private equity, or PE, today is an asset class delivering market-beating investment returns that has grown college endowments and enhanced the retirement security of millions of pension beneficiaries, including teachers, firefighters, police and other public workers. Just as important, private equity does this by helping companies grow and improve, starting from day one of an investment.

Different firms approach this in different ways, but consistent among them is the first enduring principle of private equity: alignment of interest. This refers to alignment between a company's management and the firm investing in it, but it also means alignment between the firm investing and its own investors.

At KKR, once we make an investment, we work with a company's management team to improve the balance sheet, margins, operations, and, importantly, their topline. These actions may seem obvious steps in how to create successful companies today, but when George Roberts, Jerry Kohlberg and I co-founded KKR a little over 40 years ago, they were not.

In the '70s and '80s, companies were less concerned with these efficiencies, perhaps because management was focused on other things. To help solve for this, when we were getting started, we instituted management ownership programs, a concept that was not typical in those days. Running a company as an owner unlocks value and this alignment of interest impacts company profitability substantially. I remember a board meeting at one of our investments in the '80s, a business in the oil and gas industry, where management recommended a $100 million oil exploration budget. Our first reaction was that they must be quite optimistic about their prospects to risk that much of the shareholders' capital. We pointed out to them that as shareholders who owned 10% of the company, they were putting $10 million of their own capital at risk. Moments later, management decided to reconsider the budget. One month later, the exploration budget had been cut in half, and they were acutely more focused on the results of each and every drilling site.

The opportunity to improve companies, the ability to have an alignment of interest with management and us being the shareholders with long-term, patient capital—to me, these are the hallmarks of private equity.

And while we have been focused on delivering exceptional long-term investment returns from the outset, private equity has evolved quite a bit since we started out four decades ago.

After leaving Bear Stearns to start our own firm, we had $120,000 between the three of us—$10,000 each from George and me, which was about all we had at the time, and $100,000 from Jerry who was 20 years our senior. With $120,000 in the bank, we went to raise our first fund, a $25 million private equity fund. Keep in mind there were no such funds in those days and there was no one doing what is now considered private equity. Given this environment, we had a difficult time raising the $25 million on terms that we felt made sense. So we had a thought: Why don't we go to eight individuals and ask them to put up $50,000 each for a five-year commitment and in return, we'd give them the ability to come into any of our deals. And if they did invest, we'd take 20 percent of the profits—what is known today as carried interest.

How did this happen? George's father and my father were in the oil-and-gas business where, in those days, there was something called "a third for a quarter." If you had a lease and wanted to drill, you put up 25 percent of the cost and found someone to put up the remaining 75 percent of the cost. Consequently, that person gets a two-thirds interest for what they put down and you get a one-third interest. When applying this concept to our own business, we thought 20 percent was close enough to third for a quarter, and that's still the standard today.

When we first started doing deals, private equity transactions, better known as leveraged buyouts at the time, were in their infancy. The PE industry as we know it was not yet born. In fact, we never imagined we'd ever use the term "industry" when talking about what we do.

Private equity deals looked very different than they do today. The asset class was new, and so too was its level of sophistication. As PE explored elaborate capital structures, new sources of funding, larger pools of equity capital and did so through variable economic conditions, we did not properly explain these complexities—or our mission—to the public. As a result, PE deals became associated with hostile takeovers at the time. Referring to PE as "corporate raiders" or "barbarians," the public's reaction to the very same question I asked you—what is private equity?—was simply: an investment vehicle to acquire, strip and sell an asset for profit. We never thought of it this way; we were always focused on the opportunity at hand to create value at the companies in which we invested. Nonetheless, we and others did not pay enough attention to communicating this with our various stakeholders.

Looking back 40 years later, this is one of the many lessons, perhaps the hardest, that we've learned along the way. These lessons—and the headlines referencing barbarians that came with them—are not exclusive to KKR. The experiences of the early days of PE served as a catalyst for transformation of the entire PE industry.

I think it is safe for me to speak on the industry's behalf when I say we have learned there is so much more to investing than buying low and selling high. As my colleague Bill Cornog will expand upon in Chapter 13, we've learned to think of ourselves as industrialists. When we buy a company, we ask ourselves: what can we do to make it better? How can we create value? What constituents should we be mindful of and will factor into a good outcome for everyone?

At KKR, key to answering these questions is the development of what we call 100-Day Plans. These plans are put into place as soon as we make an investment. That means we hit the ground running from the day a transaction closes. Our goal is to focus, with a sense of urgency, on the creation of value. As part of this process, we establish upfront operating metrics. These can often reveal underlying problems with a business before those problems can be seen in the financial data. In this way, we can make difficult operational and personnel decisions as early as possible in the process. Recognizing, acknowledging and addressing problems up front are part and parcel of the successful ownership model.

This value creation process involves not only understanding a company's balance sheet and financial statements, but also its employees, their impact on the world around them and being good participants in community life. This all contributes to value creation—or destruction.

As an industry, we've learned that we can make a difference by integrating our performance-focused investment philosophy with environmental, social and governance (ESG) initiatives. It is our responsibility—not only to serve our investors through great investor returns—but also to support them by investing in the communities of the corporations in which we invest. Over the years, I think the PE industry has picked up on this quite a bit.

And while that doesn't mean every company we invest in is advancing an ecological solution, I believe PE-backed companies can help solve challenges—economic or otherwise—in their communities. Whether it's improving municipal water treatment facilities, funding sustainable economic initiatives in underprivileged communities or reducing waste and promoting eco-efficiency in plants and factories, incorporating ESG practices has become a focal point throughout the lifecycle of an investment.

As I mentioned earlier, one of the key principles to making this work is the alignment of the interests of all parties—managers, investors and employees alike.

Investing alongside one's investors, or our limited partners (LPs), is the best demonstration of partnership. While the principle of alignment has not changed from four decades ago, it has definitely been emphasized more greatly in recent years. We, and others, have continued to make larger firm and employee commitments to our funds, further incentivizing our employees to do well for our investors.

With the addition of new technologies and important groups like the Institutional Limited Partners Association, there is also a focus on making sure LPs have greater visibility into the underlying details of the companies in which they are invested. This enhanced transparency is not limited to the PE industry alone, and our world is better off for it. Information is at our fingertips. This is a good thing and promotes efficiency, integrity, and accountability. In my opinion, these are the mainstays to being a trusted partner in private equity, not just to LPs but to all of our stakeholders.

Today, success in PE involves many more facets and many more faces related to a deal. Our constituents include our limited partners and their beneficiaries but also the employees of our portfolio companies, stockholders, regulators and government officials as well as the media. As the collection of stakeholders has evolved quite significantly, so has the industry's approach to engaging with them.

To succeed in PE, communication and transparency are key. As we work to build strong relationships with our stakeholders, we remember: people do business with people they like and trust.

As far as the mainstays to being a good investor? I'd say curiosity and a sense of history. To me, people who are curious are going to be far better stewards of others' money. Why? If there's no curiosity, you're basically doing something that's already been done by someone else. Moreover, being knowledgeable of the past means you can learn from past mistakes and, hopefully, not repeat them. Without these two attributes, one will miss out on opportunities, or experience slip-ups, by not seeing the whole picture.

Now I know this has been a long answer to what is private equity? In my mind, at the forefront of this lengthy explanation has been one of my favorite quotes from General Eric Shinseki: "If you don't like change, you will like irrelevance even less." The industry has gone through many changes, but by doing so, private equity continues to attract some of the most sophisticated investors in the world.

While we will have to wait and see how the asset class continues to evolve, I anticipate that private equity of the future will need to prioritize diversity to remain germane.

Too many of the same people means too much of the same thinking—an element of today's industry that I feel greatly needs to be addressed. As we discussed earlier, more of the same is a stepping stone to irrelevance. We need to value having more diverse groups of people—diversity of gender, race and ethnicity, and especially diversity of experiences and thinking. There is no doubt that diverse groups drive better outcomes—it has been proven time and again—it creates a better work environment, more creative ideas and is a critical focus area of our investors. I think this is a lesson we are in the middle of and hope the industry will heed this important message in order to succeed in the future.

So what is private equity?

You will hear many answers to this question from industry leaders in the chapters ahead, but what I hope I've made clear is that private equity is so much more than its literal definition. For me, private equity always has been and always will be about building value over the long-term.

PREFACE

Gone are the days when "being in PE"[1] meant buying assets with steady cash flows in heavily leveraged transactions and riding the investments out to a successful exit. Despite the evolution, growth and increasing diversity of PE, this dated image persists, but no longer does the industry justice.

So, what does modern PE look like? The main difference from the activities of the '70s and '80s is that PE firms have developed into transformation agents that impact businesses at critical junctures of their development. PE funds are no longer just hands-off financial investors seeking to profit through changes to the capital structure or by selling off parts of a business; as the industry has matured, PE firms increasingly engage via active ownership to drive value creation in their portfolio companies. Indeed, a partnership with PE can provide portfolio companies with the edge to remain relevant in the hypercompetitive age of globalized markets.

Although PE has become synonymous with exceptional growth and wealth generation, the industry has endured its share of challenges. In particular, each financial crisis has opened the door to controversy. The spotlight focused on the performance of leveraged buyouts in times of highly visible defaults and then switched to venture investors' ambitious start-up valuations when valuations slipped and follow-on transactions took on a distinct pass-the-parcel flavour. There are ongoing debates about the fairness of profit-sharing between limited partners and general partners (and taxation of the latter) as well as the industry's impact on its investee companies and on the economy at large.

Will the value-added focus of the PE industry become a model for the financial markets of tomorrow? Will the limited partnership model itself require dramatic changes to survive? How can we better communicate the benefits professional PE can bring to companies and not only to investors? These are some of the relevant questions being asked by senior industry players as we set out to write this book.

As PE works its way into the economies of the 21st century, board members, senior executives, finance professionals and entrepreneurs are well advised to follow the industry's development carefully. After all, whether venture funds, super angels, growth equity funds, turnaround investors or buyout funds, we are talking about gatekeepers and agents who are entrusted with the capital of their investors to find the best entrepreneurial opportunities possible, whether in developed, emerging or frontier markets.

As for students of the industry and junior PE professionals, developing a solid understanding of the overall business model of PE will enable them to develop new ways to differentiate their firms in the eyes of investors. Attractive target companies in search of funding can choose from more than 8,000 professional PE firms worldwide to find those who meet their expectations and can deliver worthwhile partnerships.

1. In the context of this book, PE is defined broadly and includes venture capital (VC), growth equity and buyout funds. More about this later in the book.

A NOTE FROM CLAUDIA ZEISBERGER

As a professor at INSEAD, one of the leading global business schools, I am fortunate to be part of a diverse, young, dynamic and entrepreneurial community. As the academic director of the school's Global Private Equity Initiative, I am often the first port of call for students, alumni, senior executives and entrepreneurs for a multitude of PE related issues, including career transitions, start-up ideas, fundraising and access to industry professionals.

For years I have been asked for a resource that would enable them to deepen their knowledge on a specific topic of PE or VC. Every class has a group of students keen to dive deeper into a variety of niche topics that cannot be addressed within the time constraints of an MBA course. To satisfy those questions and to complement my classes, I started to write "Private Equity Primers"—short, concise class notes that focused on topics that deserved more detailed coverage.

The book you are about to explore started as a collection of those primers, often written in response to conversations with industry players at conferences to shed light on areas of PE that are, by their nature, not easy to understand. The notes have been fine-tuned over many years of class use.

Supporting this book with a selection of INSEAD case studies (published in *Private Equity in Action—Case Studies from Developed and Emerging Markets*) was an easy decision. They add context to the theoretical concepts, and allow the reader to consider the potential conflicts, controversies and challenges those PE funds face when deploying capital to deserving firms in both developed and emerging markets.

News coverage of the PE industry, often embellished for dramatic effect, does a good job of fueling the imagination of anyone from laymen to seasoned financial professionals. PE, with its wide variety of colorful characters and at times unconventional strategies, is often portrayed as the boogeyman of the financial services industry—deservedly or not—depending on whom you ask. To my frustration, much of the criticism of these private investment vehicles shows a lack of understanding of the basic principles of PE and VC. Admittedly, this is a function of a traditionally opaque industry that could have done a much better job of educating the broader public on the mechanics of and benefits behind its investment activities.

This book aims to create clarity, increase the level of understanding of PE and help interested professionals not only to connect the dots, but also to support them in the process of executing that first deal, whether as a PE professional or as a board member courting the first external investor.

Two INSEAD alumni join me as co-authors for this book. Over the years, we have collaborated on various research projects at INSEAD's PE center and, through their work in the alternative investing space globally, they add another perspective to the industry.

Asking senior professionals in our network to add their thoughts to each chapter in brief guest comments and also to review our writing, was a natural extension of this principle of marrying academic rigor with the real-life challenges facing PE professionals. Our guest authors provide a candid counterpoint to our arm's length discussion and raise critical points.

The authors' views and biases of course play into the reflections; they shape the lens through which we view the world. In my case, more than 20 years in the now fully emerged markets of Asia have certainly given me a vantage point away from the standard western PE model. I have had the opportunity to observe PE firms professionalize and improve young businesses, revamp their operations and allow them to launch into an accelerated growth phase, despite owning a minority equity stake. Overall I have seen PE effect real change in the fast-growing markets of Asia and Latin America. My co-authors balance this out through their experience.

Writing this book was a fascinating journey that brought several points to light:

- PE and VC, while popular topics, are rarely, if ever, examined in the context of the broader economy.
- Industry players are often frustrated by the lack of understanding of their craft within the business community, which leads to misinterpretation and misrepresentation and at times to a backlash or unfair accusations.
- Research papers—both of the applied and academic kind—more often than not take a closer look at narrow and specific areas of PE, thereby ignoring the contextual issues. Resources to help one understand the big picture, covering the spectrum from venture to growth equity to buyouts, are few and far between.

There was room for a book to step in and fill some of the gaps to prepare all parties for an informed discussion.

HOW TO USE THIS BOOK

This book was written with a professional audience in mind and carefully structured to accommodate both graduate students and experienced professionals. It makes a solid attempt at reflecting on its central themes without judgment, by relating the facts and ensuring that readers are well prepared to participate in an intelligent discussion about the pros and cons of private equity (PE).

Used together with the case book *Private Equity in Action—Case Studies from Developed and Emerging Markets*, which complements the text, this book brings the learning points to life and offers readers a ringside seat to the day-to-day challenges facing partners in PE and venture funds.

- For novices to the field of PE, our book provides clear insights into the workings of the industry. While the book assumes a sound understanding of basic finance, accounting techniques and risk–return concepts, it offers links to literature and research to ensure clarity for those rusty in the theoretical concepts behind today's financial markets.
- Graduate and postgraduate students will find the book an invaluable companion for their PE, venture capital and entrepreneurship courses; it will allow them to connect the dots and ensure that an understanding of the dynamics in the industry is maintained as they explore the respective chapters in greater detail.
- For seasoned financial professionals, the book includes guest comments from industry experts and links to advanced literature that provides a nuanced view of the industry and will allow them to engage with other professionals, be they lawyers, bankers, consultants or partners of PE firms, in a meaningful way.

Ensuring that our readers develop a sound understanding of PE before diving into more controversial aspects of the industry was a clear goal from the outset; it defined the flow and the logic of the chapters. The book's structure allows the expert reader to use the book as a quick reference with easily retrievable highlights of the best practices employed in the industry; it also allows observers of the industry and students to work through the topics step by step and take advantage of the many resources and cross-references to other finance topics.

Overall the chapters are grouped into five sections:

SECTION I offers a high-level introduction to PE to ensure that we speak the same language and use appropriate industry terms and definitions throughout the book. It puts venture capital, growth equity and leveraged buyouts into context and describes several alternative PE investment strategies such as distressed investing and real estate.

SECTION II looks in greater detail at PE investment processes, starting with deal sourcing, due diligence and target valuation before exploring deal pricing considerations and the actual structuring of PE deals. It also includes a thorough coverage of transaction documentation.

SECTION III asks: What do PE and venture funds do with their portfolio companies during the holding period? How will they transform these businesses and prepare them for exit?

SECTION IV describes the key dynamics involved in raising a PE fund. We step into the shoes of global institutional investors in PE to examine their demands with regard to reporting and portfolio customization.

SECTION V builds on the understanding gained in the previous chapters and takes a closer look at recent developments in the industry, from direct and co-investment programs to the fast-growing secondaries markets and the recent rise of listed PE funds. In the closing chapter the authors comment on the industry's development and explore key themes that will shape private equity and venture capital in the years ahead.

Additional material to complement this book and connect it to the case book *Private Equity in Action—Case Studies from Developed and Emerging Markets* can be found on the companion website:

www.masteringprivateequity.com

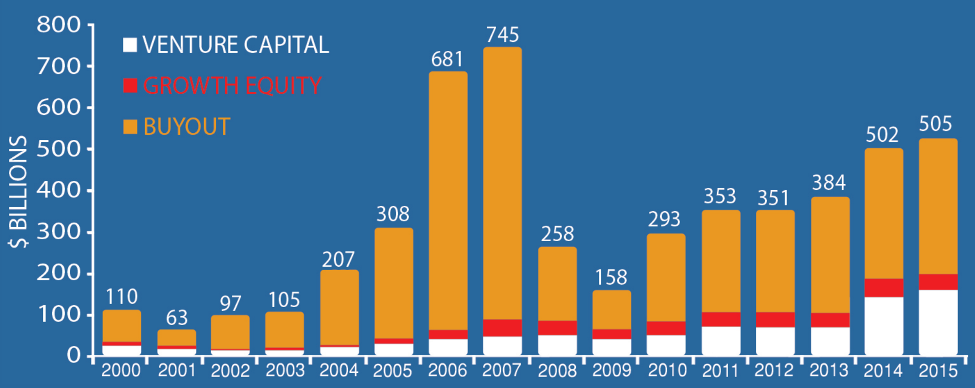
SECTION I

Private Equity Overview

The first section of the book provides readers with a high-level introduction to the institutional private equity (PE) market—from early-stage venture capital to growth equity and buyouts, plus a brief description of several alternative PE strategies. While buyouts have historically accounted for the vast majority of global PE capital deployed,[1] venture capital and growth equity investment activity has steadily increased as the industry matured over the past decades (see Exhibit A).

Section I is by far the least technical part of this book, intended to familiarize newcomers with the asset class and the concept of investing institutional capital in private companies in return for equity stakes. While crucial for readers new to PE, professionals familiar with the industry may choose to move directly to later sections of the book.

Exhibit A: Total PE Industry Capital Deployed by Strategy



Source: Preqin

1. Buyouts have accounted for more than three-quarters of industry capital deployed between 1980 and 2015. Source: Preqin.

Section Overview

Chapter 1. Private Equity Essentials: This chapter defines the traditional limited partnership fund model, specifically the players involved, a fund's investment lifecycle, and typical fund economics and fee structures. To be clear, our work refers to the organized PE market, i.e., professionally-managed equity investments by specialized intermediaries (PE firms) and their institutional backers; it excludes other forms of "informal" private capital investments.

Chapter 2. Venture Capital: Venture capital (VC) generally flows into early-stage companies—start-ups—that offer high risk/high return investment opportunities. We introduce the different types of venture investors (business angels, start-up incubators and accelerators, VC funds, and corporate VCs) and explain the use of VC at different points in a company's development, from proof-of-concept to commercialization and scaling up. Both aspiring entrepreneurs as well as future venture investors will find this chapter useful.

Chapter 3. Growth Equity: Acquiring minority equity stakes in fast-growing companies is the focus of growth equity funds. Managing multiple stakeholders without a control position is a key challenge for these funds; establishing a productive working relationship with existing managers and owners is therefore a key determinant of success. This chapter is particularly relevant for readers interested in PE in emerging markets.

Chapter 4. Buyouts: Buyout funds acquire controlling equity stakes in mature and sometimes listed target companies, often employing ample amounts of debt in leveraged buyouts (LBOs). The skillset required to execute large LBOs and drive value post-investment differs from that needed for growth equity or VC: it requires both financial and process management skills, combined with the ability to create operational value in the portfolio firms.

Chapter 5. Alternative Strategies: In the final chapter of this section, we explore alternative PE strategies focused on investing in distressed businesses and real assets. The former requires unique skills to restructure and improve a company's operations (turnaround) or its balance sheet (distressed debt), while the latter describes a range of strategies (investing in real estate, infrastructure, and natural resources) that use a PE operating model and adapt it to distinct industry verticals.

PRIVATE EQUITY ESSENTIALS 1

At some point in their development, all companies will need either a helping hand or a shot in the arm. A fresh injection of capital or external managerial expertise is often necessary to help organizations overcome developmental challenges, realize their full potential and seize the opportunities that lie ahead. Start-ups hunt for the visionary capital that will enable them to turn a concept into a launched product. Mature companies are increasingly subject to market disruption, increased competition or pressure to update manufacturing processes and corporate governance structures. Companies that have been performing poorly for a prolonged period of time need to identify and then rectify the problems that confront them. Family businesses must honestly address succession planning ("it is only but three generations from shirtsleeves to shirtsleeves"[2]).

The needs and demands of businesses at such critical inflection points often exceed the capabilities and services provided by the established financial institutions and consulting firms. Capital markets, for instance, are unlikely to offer a solution for small and medium-sized enterprises (SMEs). Into this void steps private equity (PE) in the form of venture, growth, and buyout funds, at its best offering patient and long-term capital, dedicated expert advice and hands-on operational support.

In the last four decades PE has emerged as the transformation agent of choice for companies seeking change; at times, it is the only choice for a business in need of capital and a risk-sharing partner to facilitate future growth. The PE ecosystem has grown dramatically during that time; as of 2015 the industry (including its alternative strategies and co-investments) has over US$4.5 trillion in assets under management, of which US$2.3 trillion are deployed through core PE strategies. This capital is being invested and managed by over 8,000 professional funds globally. Understanding this industry—its drivers and its dynamics—is a must for entrepreneurs, owners of family businesses, board members of multinationals and senior managers.

So what exactly is PE? PE funds invest long-term capital in private (or, at times, public) companies in return for an equity stake that is not freely tradable on a public market.[3] Our definition of PE includes so-called "take-privates" (i.e., delistings of public companies) and private investment in public equity that come with specific governance rights. This book focuses strictly on the activity of professionally managed PE funds advised by highly specialized intermediaries (PE firms) and excludes "informal" private capital, such as investments made by business angels or families who typically draw on their own private wealth.

This first chapter gives our readers a high-level overview of PE funds, by defining their structure and the motivation of the key players involved. We then explain how PE funds go about their business, both from the general partner's (GP's) and limited partner's (LP's) perspective and shed light on the often complex economics and fee structures in PE.

2. Origin unknown but the quote is often attributed to Andrew Carnegie.

3. In our context, PE takes on a broad definition that includes VC, growth capital, and buyout funds. It should be mentioned that other sources might restrict the definition of PE to buyout activities and consider VC to be a separate asset class. Further, PE is frequently defined as investments in private companies but buyout activities extend to investments in and the privatization of public companies. For the sake of clarity, our definition of "private" equity refers to the status of the equity stake held by the PE fund post-investment.

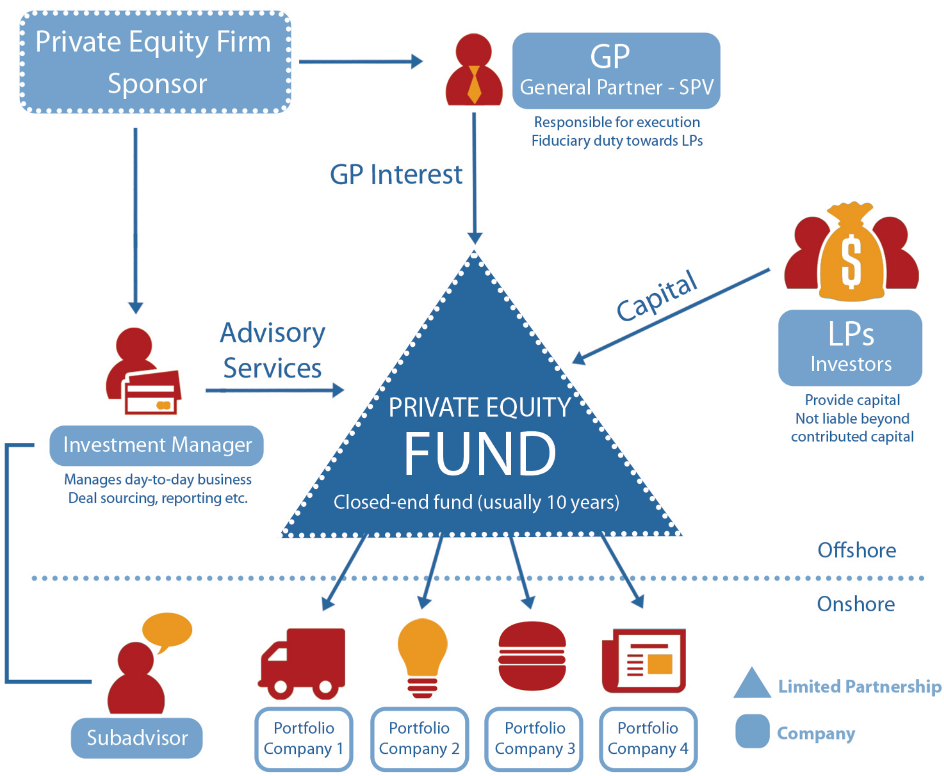
PRIVATE EQUITY FUNDS DEFINED

A PE fund is a stand-alone investment vehicle managed by a PE firm on behalf of a group of investors. The capital is raised with a clear mandate to acquire equity stakes in private companies and divest them over time.

Most PE funds globally are set up as closed-end limited partnerships and operate as “blind pool” vehicles. Closed-end funds have a finite lifespan and require investors to commit capital for the fund’s entire term—typically 10 years—without early redemption (or withdrawal) rights.[4] While investors in a PE fund have a clear idea of its broad mandate (for example, mid-market European buyouts), they have no say in the choice of the individual companies that a fund will invest in, hence the term “blind pool.” Certain jurisdictions use limited liability companies or corporate structures as the vehicle of choice for a PE fund, but they are the exception.

We will start with a closer look at the parties involved in a limited partnership PE fund structure, as shown in Exhibit 1.1.

Exhibit 1.1 Limited Partnership PE Fund Structure



4. The PE secondaries market can provide liquidity for an LP wishing to sell its interest in a PE fund. This market has developed rapidly over the last decade with dedicated funds raised for the express purpose of acquiring secondary fund stakes. See Chapter 24 Private Equity Secondaries for more information.

PE FIRM: A PE firm is a company with expertise in executing a venture, growth or buyout investment strategy. It raises and advises a fund—and, if successful, over time a family of funds—generally through two separate yet affiliated legal entities: the GP and the investment manager. Members of a PE firm typically hold all the key directorships and other decision-making positions of both the GP and the investment manager for every fund raised by the firm. Establishing these separate legal entities insulates the PE firm from liabilities related to and its principals from any claims on the PE fund. Examples of notable PE firms are buyout firms Kohlberg Kravis Roberts (KKR) and APAX Partners as well as venture firms Sequoia Capital and Kleiner Perkins Caufield Byers.

LIMITED PARTNERS: Investors or LPs contribute by far the largest share of capital to any PE fund raised. LPs participate merely as passive investors, with an individual LP's liability limited to the capital committed to the fund. Investors active in PE include private and public pension funds, endowments, insurance companies, banks, corporations, family offices, and fund of funds.[5] LPs are purely financial investors and cannot be involved in the day-to-day operation or management of the fund or its investee companies without running the risk of forfeiting their limited liability rights. LPs legally commit to provide capital for investment when it is drawn down (or "called") by the PE fund and they receive distributions of capital—including a share of profits—upon successful exit of the fund's investments.

GENERAL PARTNER: A fund's GP is wholly responsible for all aspects related to managing the fund and has a fiduciary duty to act solely in the interest of the fund's investors. It will issue capital calls to LPs and make all investment and divestment decisions for the fund in line with the mandate set out in its Limited Partnership Agreement (LPA). The GP may delegate some of the management functions to the investment manager or a PE firm's investment committee (IC),[6] but remains fully and personally liable for all debts and liabilities of the fund and is contractually obligated to invest the fund's capital in line with its mandate.[7] A GP—and in turn a PE firm's partners and senior professionals—will also commit capital to the fund to align its interest with that of the fund's LPs by ensuring that the firm's partners have "skin in the game"; the GP stake typically ranges from 1 to 5% and rarely exceeds 10% of a fund's total capital raised.

INVESTMENT MANAGER: In practice, the investment manager[8] conducts the day-to-day activities of a PE fund; it evaluates potential investment opportunities, provides advisory services to the fund's portfolio companies, and manages the fund's audit and reporting processes. The manager is paid a management fee by the fund for providing these services, some of which may be passed on to a subadvisor. The management fee is typically set at around 1.5–2% of committed capital during the investment period of the fund; after the end of the investment period, it is calculated

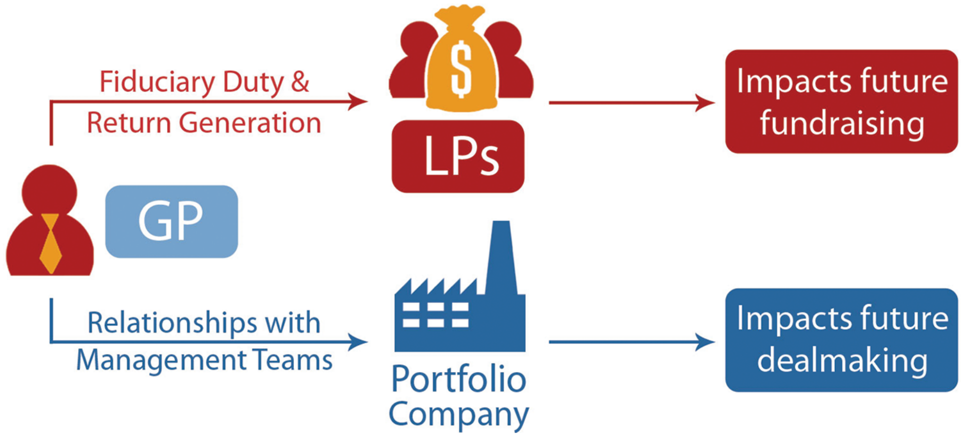
5. A fund of PE funds (fund of funds) is a vehicle that invests in a portfolio of individual investment funds. A fund of funds offers clients diversified exposure to the PE asset class without the need for deep investment expertise or lengthy due diligence on the individual funds. An additional layer of fees applies.

6. The IC is typically a committee of the GP and makes the binding investment and divestment decisions for the fund under delegated authority from the GP ("binding" in the sense that once the IC votes, there is no other vote needed or taken).

7. GPs are usually set up as distinct special purpose vehicles (SPVs) for each fund; these SPVs serve as the GP for only one fund to avoid cross-liabilities between related funds of the PE firm. Please refer to Chapter 16 for further details on fund formation.

8. Investment managers will also be referred to as advisors or simply managers.

Exhibit 1.2 Key Relationships GPs Must Manage



on invested capital and may step down to a lower rate. More information on fee structures can be found later in this chapter.

PORTFOLIO COMPANY: Over its lifecycle, a PE fund will invest in a limited number of companies, 10–15 on average, which represent its investment portfolio. These companies are also referred to as investee companies or (during the due diligence process) as target companies. A PE firm's ability to sell its stakes in these companies at a profit after a three- to seven-year holding period will determine the success or failure of the fund.

From the perspective of the PE firm and its affiliated entities, the business of PE comes down to two simple yet distinct relationships: on the one hand, the firm's fiduciary duty towards its LPs and on the other hand its engagement with entrepreneurs, business owners and management teams in its portfolio companies (Exhibit 1.2). Establishing a reputation of professional conduct and value-add will ensure access to both future fundraising and investment opportunities.

THE GP PERSPECTIVE
LIFECYCLE OF A PE FUND

A traditional PE firm's business model relies on success in both raising funds and meeting its target return by effectively deploying and harvesting fund capital. PE funds structured as limited partnerships are typically raised for a 10-year term plus two one-year extensions, commonly referred to as the "10+2" model. Generally speaking, a GP will deploy capital during the first four to five years of a fund's life and harvest capital during the remaining years. The two optional years allow the GP to extend a fund's lifespan at its discretion if and when additional time is needed to prudently exit all investments.

Exhibit 1.3 shows the overlapping timelines for the fundraising, investment, holding, and divestment periods of a closed-end fund.

Exhibit 1.3 Lifecycle of a PE Fund

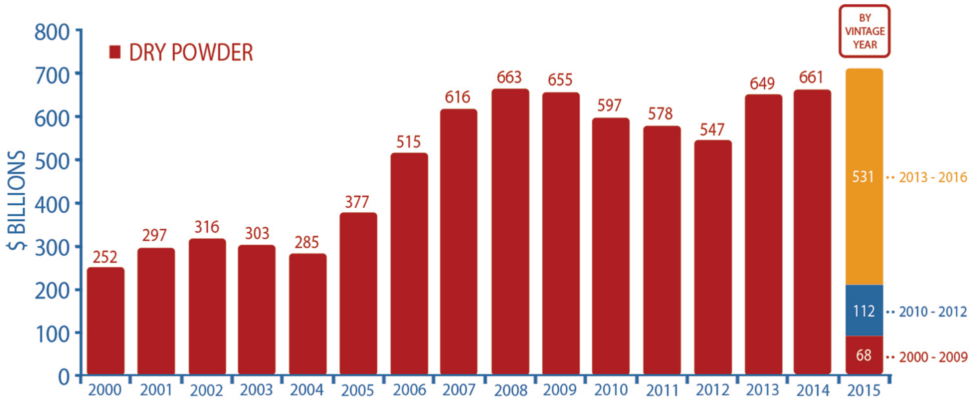
FUNDRAISING: PE firms raise capital for a fund by securing capital commitments from investors (LPs) through a series of fund closings.[9] A PE firm will establish a target fund size from the outset—at times defining a "hard cap" to limit the total amount raised in case of excess investor demand. Once an initial threshold of capital commitments has been reached, the fund's GP will hold a first closing, at which time an initial group of LPs will subscribe to the fund and the GP can start to deploy capital. A fund holding its first closing in 2016 is referred to as a "vintage 2016 fund," a fund with a first closing in 2017 will be known as a "vintage 2017 fund," and so on. Fundraising will typically continue for a defined period—12 to 18 months—from the date of the first closing until the fund reaches its target fund size and a "final closing" is held. The total amount raised by a PE firm is known as a fund's committed capital.

INVESTMENT PERIOD: Rather than receiving the committed capital on day one, a GP draws down LP commitments over the course of a fund's investment period. The length of the investment period is defined in a fund's governing documents and typically lasts four to five years from the date of its first closing; a GP may at times extend the investment period by a year or two, with approval from its LPs. Once the investment period expires, the fund can no longer invest in new companies; however, follow-on investments in existing portfolio companies or add-on acquisitions are permitted throughout the holding period. A fund's LPA may also permit its GP to finance new investments from a portion of fund realizations within a certain limited period after divestment (this is known as the recycling of capital), thus increasing a fund's total investable capital.

GPs draw down investor capital by making "capital calls" to fund suitable investment opportunities or to pay fund fees and expenses. LPs must meet capital calls within a short period, typically 10 business days. If an LP fails to meet a capital call, various remedies are available to the GP. These include the right to charge high interest rates on late payments, the right to force a sale of the defaulting LP's interest on the secondaries[10] market and the right to continue to charge losses and expenses to the

9. Please refer to Chapter 17 for more details on the fundraising process and its dynamics.
10. Please refer to Chapter 24 Private Equity Secondaries for further details on the mechanics behind the transfer of such LP stakes.

Exhibit 1.4 PE Industry Dry Powder



Source: Preqin

defaulting LP while cutting off their interest in future fund profits. The portion of LPs' committed capital that has been called and invested is referred to as contributed capital. A fund's uninvested committed capital is referred to as its "dry powder"; by extension, the total amount of uninvested committed capital across the industry is referred to as the industry's "dry powder." Exhibit 1.4 shows the increase of the industry's dry powder since 2000; the 2015 data adds perspective on its origin by grouping dry powder according to vintage year.[11]

HOLDING PERIOD: Holding periods for individual portfolio companies typically range from three to seven years following investment, but may be significantly shorter in the case of successful companies or longer in the case of under-performing firms. During this time, a fund's GP works closely with portfolio companies' management teams to create value and prepare the company for exit.[12]

DIVESTMENT PERIOD: A key measure of success in PE is a GP's ability to exit its investments profitably and within a fund's term; as a result, exit strategies form an important part of the investment rationale from the start.[13] Following a full or partial exit, invested capital and profits are distributed to a fund's LPs and its GP. With the exception of a few well-defined reinvestment provisions,[14] proceeds from exits are not available for reinvestment. When a fund remains invested in a company at the end of a fund's life, the GP has the option to extend the fund's term by one or two years to avoid a forced liquidation.[15]

11. Dry powder in Exhibit 1.4 is for venture, growth and buyout investment strategies. Source: Preqin.
12. Please refer to Chapter 13 Operational Value Creation for more background.
13. Please refer to Chapter 15 for a detailed description of exit considerations and the related processes.
14. The capital invested in a deal and returned without any profits achieved, may be reinvested under the following conditions: (a) a so-called "quick flip" where an exit was achieved within 13–18 months of investing during the investment period; or (b) to match the amount of capital drawn down to pay fees, with the target to put 100% of the fund's committed capital to work. These rules are defined in a "remaining dry powder" test.
15. Please refer to Chapter 20 Winding Down a Fund for additional information on end-of-fund life options.

Box 1.1

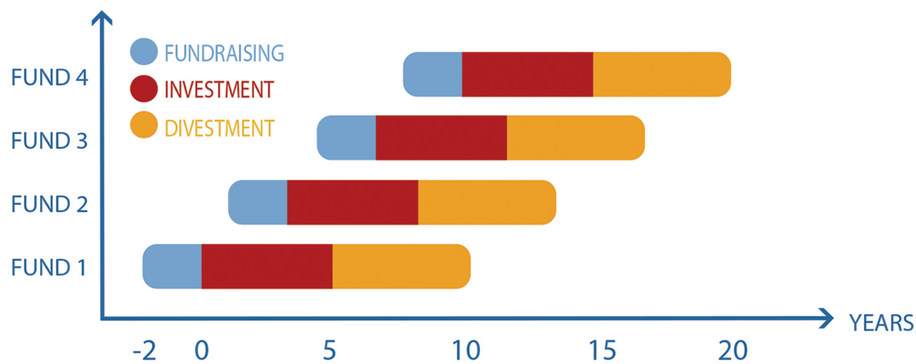
RAISING A SUCCESSOR FUND

Established PE firms will raise successor funds every three to four years and ask existing LPs to "re-up"—or reinvest—in their new vehicle. PE firms will typically begin raising a successor fund as soon as permitted by the LPA, usually once 75% of the current fund's capital is invested or has been reserved for fees and future deals.

PE firms see their business as a going concern, meaning they continuously work on a deal pipeline of potential investee companies, make investments and divestments. To efficiently capitalize on opportunities in the market, it is crucial for PE firms to have access to capital, ready to be drawn down and deployed, at all times. This also allows a firm to maintain stable operations, employ an investment team and maximize the efficiency of its resources.

Exhibit 1.5 shows the lifecycle of a successful PE firm with a family of four funds.

Exhibit 1.5 Lifecycle of a Successful PE Firm



THE LP PERSPECTIVE
COMMITTING CAPITAL AND EARNING RETURNS

Investors have traditionally allocated capital to PE due to its historical outperformance of more traditional asset classes such as public equity and fixed income.[16] However, this outperformance comes with higher (or rather different) risks first and foremost due to the illiquid nature of PE investments. Given its lack of liquidity and the long investment horizon of a PE fund, hitting a target allocation to PE is a far more challenging task than maintaining a stable allocation to any of the liquid asset classes.[17] In addition, PE funds' multiyear lock-up and 10-day notice period for capital calls introduce complex liquidity management questions.

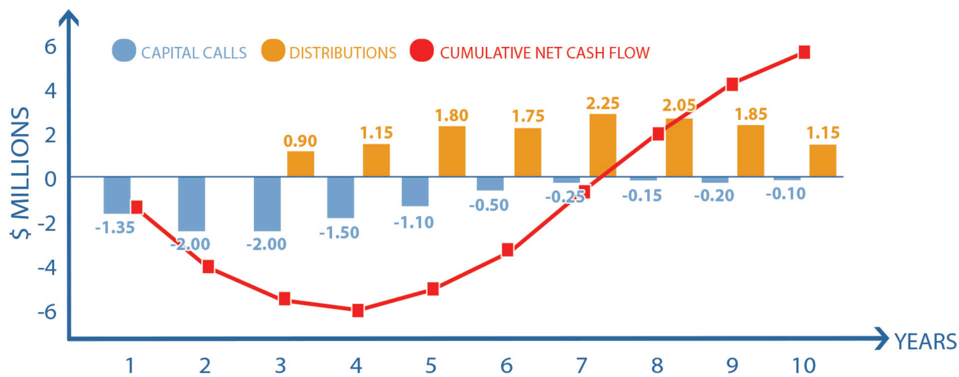
16. Please refer to Chapter 19 Performance Reporting for a detailed comparison of PE and public market performance.
17. Our Chapter 18 LP Portfolio Management takes a closer look at the challenges of deploying assets under management into PE and VC; Chapter 23 Risk Management complements the discussion.

Effectively managing portfolio cash flows is among the key challenges faced by investors in the PE asset class. LPs starting a PE investment program from scratch must prepare for years of negative cumulative cash flows before a positive net return will eventually be generated by their PE portfolios. Seasoned investors with a well-diversified exposure to PE, on the other hand, will often have commitments to well over 100 funds and a complex set of cash flows to manage. A PE fund's "J-curve" provides a way to visualize the expected cash flow characteristics of an LP's stake in an individual PE fund and the challenges related to managing a PE portfolio.

THE J-CURVE

A PE J-curve represents an LP's cumulative net cash flow position—the total capital invested along with fees paid to the PE firm minus the capital returned to the LP by the GP—in a single fund over time. Exhibit 1.6 illustrates the characteristic cash flow for an LP (with a US$10 million commitment to a $100 million fund) over the fund's 10-year life. For simplicity's sake we assume both consistent drawdowns from the GP and exits split evenly across the years. It should be noted that capital calls and distributions are difficult to forecast with any degree of accuracy, requiring LPs to develop a flexible approach to cash management.[18]

Exhibit 1.6 PE Fund Cash Flow J-curve



Early in the investment period, the J-curve has a steep negative slope, as a fund's initial investments and management fees (paid on committed capital) result in large cash outflows for its LPs. As the fund begins to exit its portfolio company holdings, distributions of capital slow the J-curve's descent; some funds may in fact show a positive slope before the end of the investment period. While the low point of a J-curve is theoretically defined as the fund's total committed capital, J-curves rarely dip below 80% of committed capital due to the time required to deploy capital and early divestment activity. In fact, many funds do not even reach a net drawdown of more than 50%.

Following the start of the divestment period, the J-curve turns upward as exit activity picks up and invested capital plus a share of profits are returned to LPs. Capital called for follow-on investments and management fees continue to generate small LP outflows during the divestment period. As soon as the J-curve crosses the x-axis, the fund has reached breakeven; the final point on the J-curve represents an LP's total net profit generated by the fund.

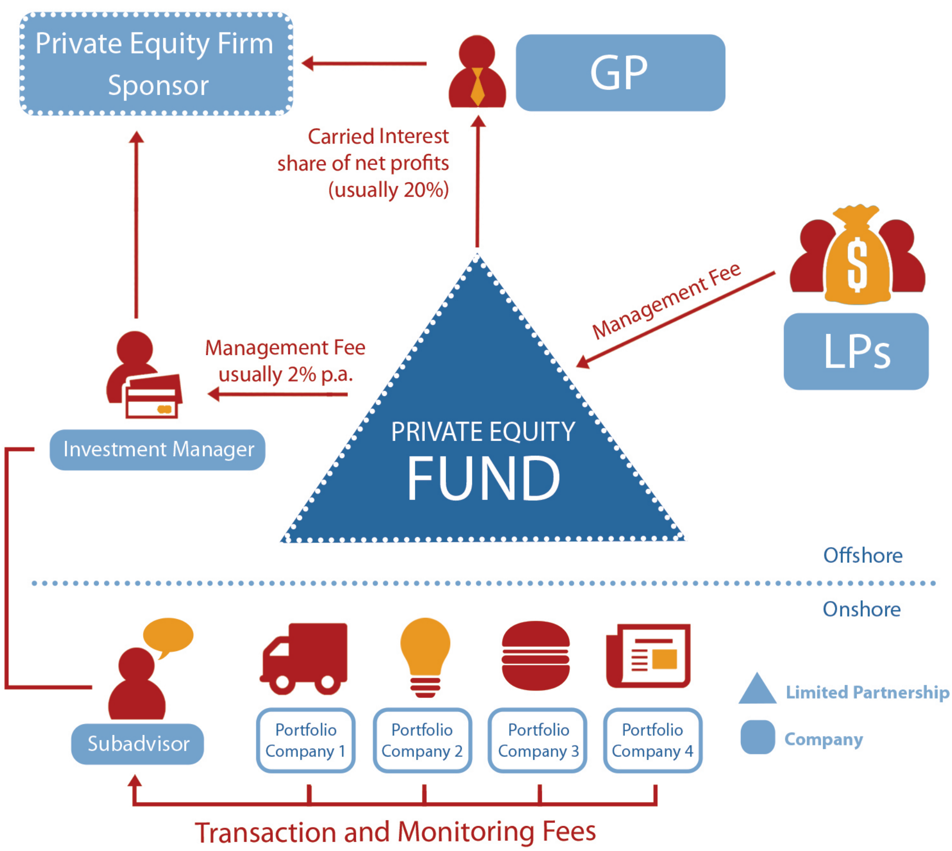
18. Please refer to Chapter 18 for further insight into the cash management challenges LPs face when starting a PE investment program or when managing multiple funds in a PE portfolio.

While LPs will attempt to optimize their portfolio allocation, modeling cash flows as well as net asset values remains challenging, given the blind pool nature of the funds and the overall scarcity of data in PE. The secondaries market nowadays offers a realistic avenue to add liquidity, shorten the J-curve and manage a PE portfolio proactively.

THE FEE STRUCTURE AND ECONOMICS OF PE
OR WHO EARNS WHAT?

The typical fee structure of a PE fund is designed to align the economic interest of the PE firm and its fund investors. The fee structure in PE is commonly referred to as "2 and 20" and defines how a fund's investment manager and GP—and in turn its PE professionals—are compensated: the "2%" refers to the management fee paid by the LPs per annum to a fund's investment manager while the "20" represents the percentage of net fund profits—referred to as carried interest or "carry"—paid to its GP. The clear majority of profits, 80%, generated by a fund is distributed pro rata to a fund's LPs. As long as carried interest remains the main economic incentive for PE professionals, their focus will continue to be on maximizing returns, which in turn benefits the LPs. Exhibit 1.7 visualizes the flow of fees and share of net profits to the entities involved in a PE fund.

Exhibit 1.7 PE Fees and Carried Interest



Returns in PE are typically measured in both internal rate of return and multiples of money invested.[19] Given a fund's cost structure, its net return—that is, the return on capital generated by the fund net of management fees and carried interest—is the relevant metric for its investors and LPs will ultimately define success on that basis at the end of the fund's life.

We take a detailed look at fees and carried interest below.

MANAGEMENT FEES: A PE fund's investment manager charges the fund—and ultimately its LPs—an annual management fee to cover all day-to-day expenses of the fund, including salaries, office rent and costs related to deal sourcing and monitoring portfolio investments. In the early days of PE, the management fee charged was an almost consistent 2% per annum, yet currently it ranges from 1.3 to 2.5% depending on the size and strategy of a fund and the bargaining power of the PE firm during fundraising. For example, it is accepted that smaller, first-time funds will charge higher fees to cover their fixed costs, while large funds and mezzanine funds often charge lower fees. Since the global financial crisis of 2008 management fees have come under pressure, sometimes in an indirect way, through a sizable increase in free or discounted co-investment opportunities for LPs.[20]

Management fees accrue from a fund's first closing onwards and are usually paid either quarterly or semi-annually in advance. Management fees are charged on committed capital during the investment period, and on net invested capital after the investment period; the rate charged on invested capital may step down from the initial percentage.[21] This fee structure causes fee revenue to drop over the lifetime of a PE fund as capital is deployed and exits occur. Early in a fund's life, management fees are typically drawn directly from investors' committed capital, while proceeds from profitable exits may be used to offset management fees later in a fund's life.

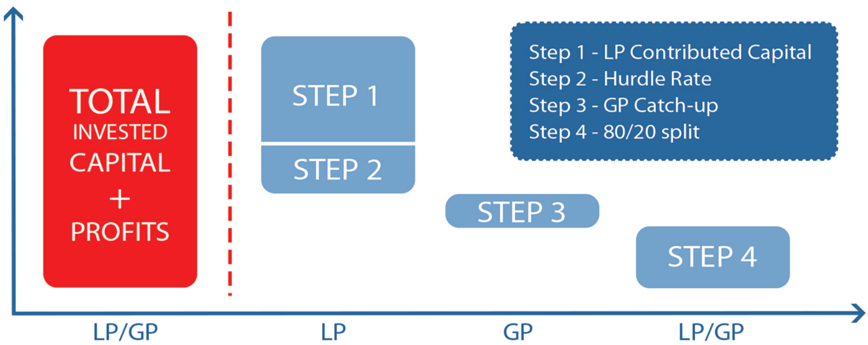
OTHER FEES: An investment manager may charge additional fees to the fund, particularly in the context of a control buyout. The main fee categories are transaction fees linked to a fund's investment in and exit from a portfolio company and monitoring fees for advisory and consulting services provided to portfolio companies during the holding period. Other fees also include but are not limited to broken deal fees, directors' fees, and other fees for services rendered at the fund or portfolio company level. Over the last decade, management fee offsets have increasingly been included in LPAs; when these offsets are in place, management fees charged to the LPs are reduced by a percentage of "other" fees collected by the fund—historically between 50 and 100%, now trending towards 100%. These offsets reduce the fee burden for LPs and shift a portion of the fee-based compensation from the GP to the limited partnership as a whole.

CARRIED INTEREST: Proceeds from successful exits are distributed to a fund's LPs and its GP in line with a distribution "waterfall" set out in a fund's LPA.[22] Carried interest is the share of a fund's net profits paid to its GP—typically 20%—and serves as the main incentive for a PE firm's principals. In a typical distribution waterfall, PE funds will return all invested capital and provide a minimum return to investors—a fund's hurdle rate[23] or

19. See Chapter 19 Performance Reporting for additional detail on fund performance measurement.
20. See Chapter 21 for further details on this co-investment trend.
21. Net invested capital consists of contributed capital minus capital returned from exits and any write downs of investment value.
22. Please refer to Chapter 16 Fund Formation for a detailed description of distribution waterfalls and examples of carried interest calculations.
23. The hurdle rate, typically set at 8%, will be negotiated during fundraising. A fund is only "in the carry" (i.e., performance incentives for the GP kick in) once it has reached an annual return of 8%.

preferred return—before any carried interest is paid out to the GP. After the hurdle rate has been reached, PE funds will typically include a "catch-up" mechanism that provides distributions to the GP until it has received 20% of all net profits paid out up to this point. Thereafter, all remaining profits are split at the agreed-upon carried interest percentage (80–20). Should a GP for any reason receive more than its fair share of profits, a clawback provision included in a fund's LPA requires GPs to return excess distributions to the fund's LPs. Exhibit 1.8 shows the basic steps common to all distribution waterfalls.

Exhibit 1.8 PE Fund Distribution Waterfall



The industry uses two standard models to calculate distributions to LPs:

- *All capital first:* Also known as a *European-style waterfall*, this structure entitles a GP to carried interest only after all capital contributed by investors over a fund's life has been returned and any capital required to satisfy a hurdle rate or preferred return has been distributed.
- *Deal-by-deal carry (with loss carry-forward):* Also known as an *American-style waterfall*, this structure entitles a GP to carried interest after each profitable exit from a portfolio investment during the fund's life, but only after investors have received their invested capital from the deal in question, a preferred return and a "make whole" payment for any losses incurred on prior deals.

A detailed description of distribution waterfalls together with examples of carried interest calculations can be found in Chapter 16. Fund Formation.

A Look Back at the Last 45 Years

By T. Bondurant French, Executive Chairman, Adams Street Partners

In reflecting on the changes in the private equity industry over the last 45 years, fundraising trends were one of the first things that stood out. Looking at fundraising data for the private equity industry, I was a little taken aback to see that 1960 through 1983 were barely visible on my bar graph, compared to the funds being raised today. In 1972, $225 million was raised for venture funds in the US; buyout funds didn't exist and Kleiner Perkins was a first time fund. Venture fundraising bottomed in 1975 at $60 million.

By 1979, the economy was better, capital gains tax rates had been lowered from 50% to 28%, venture-backed companies were bounding (Intel, Microsoft, Apple, and Genentech), and $800 million was raised for venture funds. In the early 1980s, venture funding really took off on the back of excellent returns and a rising stock market. In 1983, $3.7 billion was raised and for the first time the term “mega fund” was used.

It is hard to imagine today, but we had no real data to evaluate the managers with and there were very few realized deals. Almost everyone was a first time fund and there were virtually no formal standards in place. Benchmarks, quartile rankings, written valuation guidelines, and placement agents did not exist. Neither did industry conferences and newsletters, with the exceptions of the National Venture Capital Association’s annual meeting and the Venture Capital Journal. The fax machine hadn’t yet been invented, but a new venture-backed company, Federal Express, helped us with overnight documents.

Back then, fundraising was exceptionally difficult. Most pension consultants did not follow or cover the asset class. We spent a lot of time doing educational presentations for trustees and their consultants at offsite retreats, board meetings and pension conferences. During the 1980s, our hard work finally began to pay off. As we had actual data going back to 1972, we became pension funds’ source of information on expected returns, standard deviations and correlation coefficients for the private equity “asset class.” The new term “asset class” implied a transition from a niche activity to something that was becoming institutional. We took the lead in establishing the first industry performance benchmarks, chaired the committee that established the private equity valuation guidelines, and worked with the CFA Institute to establish the guidelines for private equity performance reporting.

Throughout the 1970s and for most of the 1980s, we had lived in a US and venture-centric world. Now, the buyout business was emerging as a new practice within the world of private equity. Pioneered by KKR, CD&R and a handful of other firms, the use of leverage to buy and manage a company was a new idea. The development of the high yield bond market, led by Michael Milken of Drexel Burnham Lambert, made this practically possible on a much wider scale than previously thought. Heretofore, “junk bonds” were formerly high grade bonds of companies that got into trouble and were in or likely to be in default. The idea of a new issue “junk bond” was a new concept.

In 1980 only $180 million was raised for buyout funds in the US. This grew to $2.7 billion in three years, and $13.9 billion by 1987. As with many things in the financial and investment markets, this was a good idea carried to an extreme, culminating in the takeover of RJR Nabisco in 1989 by KKR (as told in a book and a movie, both called *Barbarians at the Gate*).

During the second half of the 1980s, managers in Europe and Asia began to adopt “American style” venture capital and buyout practices. Many of these managers made fundraising trips to the US as, relatively speaking, there were more willing investors there. Along with pension funds and endowments, nearly all of the private equity funds of funds were based in the US.

By 1990, the US was in a recession and a savings and loan crisis. Buyout fundraising dropped dramatically, with only $6 billion raised in 1991. Fortunately, lessons were learned by all parties and the buyout business grew steadily and more rationally throughout the 1990s. What were originally highly leveraged transactions morphed over time to become today's private equity industry, which provides a variety of equity capital, including growth capital, to a broad range of industries and businesses.

By the mid-1990s, the globalization of the private equity market was on the horizon. A number of venture and private equity managers were becoming established in emerging markets. By the mid-2000s, institutional investors were interested in global exposures enhancing their diversification and return potential by accessing rapidly growing economies. Significant money was raised by Asian general partners, particularly in China. Fast forward to today, the private equity industry has expanded to nearly every corner of the globe.

While many things about the private equity industry have changed over the last 45 years, several things remain the same. Private equity remains a people business and, at Adams Street, we understand that the people we invest with are of paramount importance. Spending time with them is an important part of developing real relationships based on trust and mutual respect. Nothing has changed in that regard and these relationships are a critical part of our investment process. The characteristics of successful private equity firms are the same today as they were decades ago. It takes mutual respect, independent thinking, and an optimal mix of experience and energy. At the heart of all enduring firms are good investors who have time to work with their companies, an international awareness and network, and a differentiated deal flow edge.

I am very proud of what the private equity industry does. We generate above average returns for our investors while also providing capital to finance business growth. This financing cuts across a wide spectrum of company stages, industries, and geographies. The end result is greater growth in job creation, wealth, and GDP than would otherwise be possible.

CLOSING

PE as an asset class continues to grow and evolve, both in developed and emerging markets. Business operators the world over—from entrepreneurs looking for start-up funding, to SME business owners with global ambitions, to management teams interested in buying out a corporate division—often find the right partner in PE funds to invest in their ambitions. As a result, PE is deeply entrenched in the economic model and will remain an important driver of business transformation globally.

KEY LEARNING POINTS

- **PE is a simple business—buy a stake in a company (minority or majority), improve the business and sell it after a (limited) holding period.**
- **The preferred method employed by PE firms is to raise and invest individual funds, which they manage on behalf of investors (LPs). PE funds are typically structured as closed-end limited partnerships that require investors to commit capital for a period of 10 years or more.**
- **PE funds differ from traditional asset classes due to their illiquidity and the unpredictable cash flows generated from their investments.**
- **Both the fee structure and profit sharing arrangements in PE ensure alignment of interest; incentives change as the funds mature.**

RELEVANT CASE SUDIES

from *Private Equity in Action—Case Studies from Developed and Emerging Markets*

Case #1: Beroni Group: Managing GP–LP Relationships

Case #3: Pro-invest Group: How to Launch a Private Equity Real Estate Fund

Case #6: Adara Venture Partners: Building a Venture Capital Firm

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VENTURE CAPITAL 2

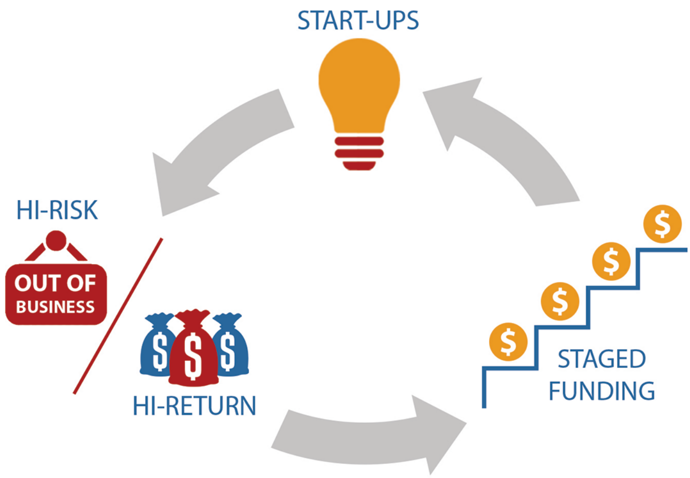
From iconic brands, such as Google, Facebook, Uber and Alibaba to blockbuster biotech or renewable energy companies, venture capital (VC) has funded and nurtured some of the most influential companies in today's global economy. Along with these runaway successes, however, VC has also been center-stage for some of the more spectacular flameouts in modern finance, from the bursting of the tech-bubble at the turn of the millennium to the storybook valuations of numerous billion-dollar "unicorns"[1] a decade and a half later. This "hit-or-miss," "all-or-nothing" character of venture investing drives both the mystique of the industry and on-the-ground decision-making bias of VC investors.

This chapter explores the dynamics of the VC industry, starting with the defining characteristics of VC investing and the unique elements differentiating it from growth equity and buyouts.[2] We then turn to the other side of the table and briefly touch on fundraising for early-stage firms and start-ups; first-time entrepreneurs preparing to raise funds will find this chapter useful to understand the dynamics inside a VC firm before entering into discussions with one of its partners.

VENTURE CAPITAL DEFINED

VC funds are minority investors betting on the future growth of early-stage companies—defined as pre-profit, often pre-revenue and at times even pre-product start-ups. Despite the lack of a controlling stake, VCs are among the most active investors in the PE industry and use their capital, experience, knowledge and personal networks to nurture and grow young companies. VCs may invest in specific verticals, technologies, and geographies, and often specialize in a distinct substage of investment, referred to as early-stage, mid-stage or late-stage VC funding. While every VC firm is unique, a few defining attributes apply to most, as detailed in Exhibit 2.1.

Exhibit 2.1 Defining Characteristics of Venture Capital



1. "Unicorns" is an industry term for private companies with valuations above US$1 billion.
2. Please refer to Chapter 3 Growth Equity and Chapter 4 Buyouts for in-depth discussions.

START-UP COMPANIES: VC funds invest in start-ups and guide them through their early years of development, as they seek to establish defensible market positions in rapidly expanding industries by disrupting existing products and services through innovation. A start-up can range from an early-stage company with a limited operating history—i.e., an entrepreneur, an idea, and a PowerPoint presentation—to a late-stage company with a fast-growing business. As a result, the capital requirements of start-ups vary widely, from a few thousand dollars to facilitate the development of an early prototype to significant injections in the tens or sometimes hundreds of millions of dollars to drive revenue growth at companies with billion dollar valuations.

Start-ups all face one common challenge: reaching the next stage of development and raising fresh capital before running out of cash. A negative monthly cash flow and high burn rates are the order of the day at a start-up, and regular injections of capital are needed to maintain and expand operations. This requires a management team that can carefully balance aggressive growth targets with the reality of a company at the pre-revenue stage. As such, venture capitalists carefully assess the founding team as much as the business concept of a start-up and prefer backing experienced entrepreneurs. A VC firm's knowledge in a given vertical and its ability to add value through mentorship and active engagement can be critical elements of success for the start-up; for entrepreneurs, this expertise is a differentiating factor when choosing from a group of potential investors.

HIGH RETURNS AND HIGH RISKS: Research shows that on average two-thirds of the investments made by a VC fund lose money and one-third of VC-backed companies eventually fail. For VC funds to achieve their fund-level target return,[3] low-performing and failed investments must be offset by at least one or two highly successful—and highly visible—investee companies that generate a return of 10 times (10×), 100 times (100×) or more on the VC's invested capital. These "home runs" often return 100% or more of a single fund's committed capital and determine the success of an entire fund. This tail-heavy, feast-or-famine return profile underscores both the riskiness of VC investing and the significant risk appetite required from limited partners (LPs) to include VC funds in their private equity (PE) programs.[4]

The high risk of VC investments has a distinct impact on venture capitalists' investment decisions and their portfolio management style. Reflecting on the risk of failure, VCs require high deal-level target returns when exploring the next investment: a 40–80% target internal rate of return is not unusual and feeds directly into the valuation and equity stake underpinning the investment.[5] VC funds typically invest in more companies per fund than growth or buyout funds to increase the chances of a "home run" and to diversify their risk. The larger number of portfolio companies and the high rate of failure require VCs to make tough decisions and (potentially) write off underperforming investments quickly to focus their time and resources on the most promising companies. Entrepreneurs are well advised to be aware of these dynamics before presenting their business plans to a VC fund.

The risk–return dynamics of VC investing are a concern for its investors. While limited partners remain intrigued by the industry's well-publicized winners and

3. Chapter 19 Performance Reporting explains the dynamics of fund-level returns in greater detail.

4. Chapter 18 LP Portfolio Management discusses the decision-making process when allocating to PE in detail.

5. Please refer to Chapter 7 Target Valuation for a worked-out example on VC valuation.

its fabled returns, a landmark report by the Kauffman Foundation published in 2012[6] raised doubts on the return contributions from venture to an institutional portfolio, implying that the risks may outweigh the strategy's return and that LPs make decisions based on "seductive narratives like vintage year and quartile performance." It suggested that the LP investment process may be broken, and that LPs have themselves "created the conditions for the chronic misallocation of capital."

FUNDING IN STAGES: VC funding is raised via discrete rounds of investments. Each round will fund a start-up's operations for a specific period of time and enable the company to reach a predefined operating milestone.

Deploying funding in stages allows a VC fund to assess the progress of the company against milestones and allocate follow-on capital to the best performing companies in its portfolio. By spreading its capital out, the fund can invest in more companies thereby "buying an option" in more potential blockbusters. It also enables individual VC firms to specialize in a specific phase of company development, from early stage to late stage, and offer stage-appropriate expertise.

Successful VC-backed companies are typically funded through progressively larger rounds of preferred equity.[7] Each subsequent VC investor will look for positive momentum (as proof of the company's value proposition) and for signs of successful execution. The preferred shareholding structure establishes a hierarchy of claims on future proceeds in the event of an exit…or liquidation.

In each financing round, entrepreneurs and existing investors give up a share of their equity in exchange for additional capital, with the percentage largely depending on the amount to be raised and the new investor's return expectations, which take into account the company's riskiness and its forecasted value at exit.

In the case of a successful start-up, raising capital step by step allows an entrepreneur to benefit from progressively higher valuations and give up less equity per dollar raised as the business matures.

START-UP DEVELOPMENT
VENTURE CAPITAL TARGETS

A start-up will navigate several stages of development before reaching profitability and a steady state of operation. Along the way, the company draws capital and expertise from different types of investors in the VC ecosystem. While each start-up follows a unique path, three distinct stages of development can be defined: proof-of-concept, commercialization, and scaling up. It should be noted that the vast majority of start-ups will never reach this final phase of accelerated growth.

6. Kauffman Foundation; 'We have met the enemy – and he is us'; (2012).
7. Please refer to Chapter 9 Deal Structuring and to the Glossary in the back of the book for more details on the different share classes used in VC.

Exhibit 2.2 Start-up Development and Funding

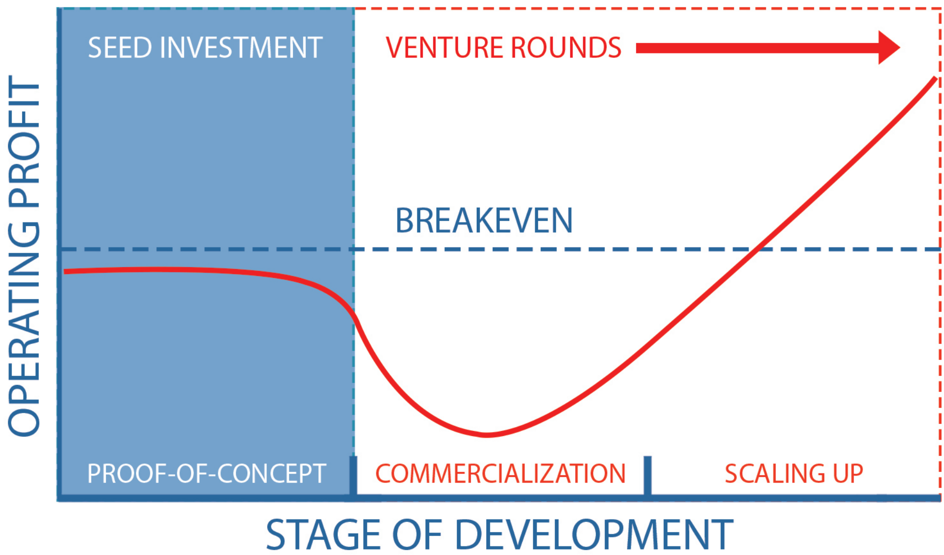


Exhibit 2.2 highlights the type of investment required at the respective stage to successfully grow and scale a business.

PROOF-OF-CONCEPT: Companies at this stage have little or no track record and only a concept of a product, technology or service. Small amounts of funding are required to conduct product feasibility studies, define relevant markets, formulate a business plan, and develop a prototype. Once the product or service is developed, engaging with and securing a user base to show that the idea has the potential to translate into a successful long-term business is a critical step to achieving proof-of-concept and attracting further funding; it also shows that the founding team has the ability to execute. During the proof-of-concept stage, company development is funded by seed investment often provided by the entrepreneur, friends and family, business angels or seed-stage VC investors.

COMMERCIALIZATION: After a company's value proposition has been validated by a group of core customers the focus shifts to translating the idea into an operating business and growing the top line. Companies at this stage of development focus on refining the product or service offering, expanding the sales and marketing functions, filling out missing capabilities in the core management team, and targeting large-scale customer acquisitions. They start to generate revenue but are far from cash flow positive; building up operations naturally increases operating cost, which combined with the initial working capital and capital expenditure needed in a growing business results in a high burn rate. In many cases, funding raised from VCs to drive commercialization are the first injections of institutional capital.

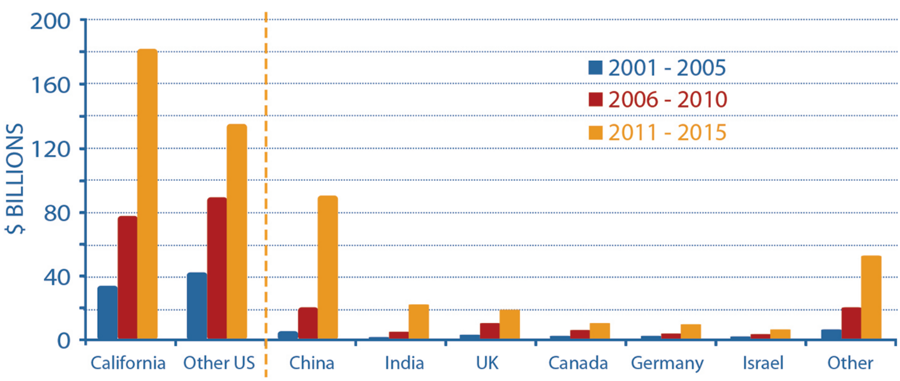
SCALING UP: This stage is all about expansion and market penetration. By now, companies are typically growing exponentially and are on their way to profit or even operating cash flow breakeven. However, profits generated from operations are reinvested in the company and may need to be supplemented by additional VC funding to meet market demand. In addition to rapidly growing a start-up's core offering, funding is needed to expand product and service offerings to differentiate the company from competitors and to balance product-specific sales fluctuations. Mid- and late-stage VC investors, along with growth equity funds, are the main investors at this stage.

Box 2.1

VENTURE CAPITAL REMAINS US FOCUSED

Geographic location is crucial for VC as an asset class, given the importance of networks when growing early-stage companies. The deepest, most "developed" VC ecosystems can be found in the United States—Silicon Valley in particular—but other geographies such as China, India, Europe and Israel have seen active clusters emerging. Successful VC communities not only have complementary funding vehicles that support early-stage growth with angel investors, crowdfunding platforms, corporate venture capital, and government funding vehicles, but provide ready access to follow-on rounds and serve as magnets to attract the talent needed to scale quickly. Exhibit 2.3 shows the total amount of venture capital invested by geography over three consecutive five-year periods starting in 2001.

Exhibit 2.3 Global VC Investment by Geography



Source: Preqin

THE VENTURE CAPITAL INVESTMENT PROCESS
UNIQUE ELEMENTS

The immaturity of companies targeted by VC funds introduces a range of unique elements into the VC investment process. Identifying future unicorns is an art, while structuring an investment to mitigate the investment risk involved is rather a science. We explore these elements in the section that follows.

DEAL SOURCING: Deal sourcing in venture is closely related to the reputation of the VC firm and the partners involved; established and well-known firms will have a regular stream of calls, pitch books and ideas flowing their way. Partners will also attend the various demo days of accelerators or industry conferences to scout for potential targets. When screening investment opportunities, VC investors' gut-feel about a start-up and its team is a crucial component and often drives the decision to pursue a specific deal. Nevertheless, questions revolving around the entrepreneur, the team's experience and motivation and the uniqueness, defensibility and scalability of the business model tend to feature prominently in those early discussions.

VALUATION: Determining the valuation of an early-stage investment is a highly subjective process.[8] While a company's current operations and future cash flow forecasts are a key component in establishing its value, so too are the robustness of its team, the strength of the business model and the size of the addressable market. As early-stage companies are typically unprofitable, investors employ multiples of revenue and other key performance indicators to arrive at a "post-money valuation,"[9] which also determines the equity split following an investment round. The expected number of future fundraising rounds will also impact valuation, as they will lead to dilution of the equity stakes for both entrepreneurs and past VC investors.

HANDS-ON SUPPORT: Many successful entrepreneurs join VC firms to become early-stage investors themselves. The best VC funds will therefore draw on a strong bench of partners, who not only have an intimate understanding of the challenges faced by their portfolio companies, but also come with their own hard-earned experience to give credible advice. Venture partners mentor management teams, help develop the marketability of a start-up's product or service, identify and fill holes in its team, and facilitate the development of business processes required to scale up. Venture capitalists are also a key resource for start-ups when raising new rounds of capital, both in shaping the fundraising message and identifying potential investors in their network.

SYNDICATED DEALS: While "club deals"[10] are rare in growth equity and buyouts, venture rounds are quite often funded by multiple VCs. Typically, a lead investor will engage with the entrepreneur and founder, conduct due diligence, arrive at a valuation, negotiate terms and commit to funding a portion of the round. Once the lead investor establishes the commercial terms, a group of "followers" will join the round.[11] The lead investor will typically invest the largest amount of capital in a round, and will be the one to engage with the start-up post-investment. This type of club investment allows VC funds to diversify their risk and gain access to a wider range of investment opportunities.

8. See Chapter 7 Target Valuation for further details on VC valuation techniques and a worked example.
9. Subtracting invested capital from a post-money valuation establishes the "pre-money" valuation.
10. Club deals are PE investments made by two or three PE funds; they were particularly fashionable for large buyouts during the years leading up to the global financial crisis in 2008.
11. Existing investors often participate in subsequent rounds to maintain their ownership percentage in the business and to signal both their continued support and overall health of the business.

Box 2.2

VENTURE CAPITAL TERM SHEETS

Term sheets serve as the main negotiation tool in VC fundraising and, once agreed upon, set out the rights and obligations of investors in a round's newly created preferred share class. The provisions of the term sheet are then formalized in a share subscription agreement, and in an amended or redrafted shareholders' agreement plus articles of association of the target company.[12]

First-time entrepreneurs are well advised to carefully review the terms under negotiation before signing a term sheet, especially as earlier investment rounds set the ground rules for future fundraising, potentially complicating that process. Guidance from an experienced entrepreneur or a friendly venture partner can help overcome the knowledge gap between start-up founders and seasoned VC investors.

The provisions in a term sheet can be divided into economic terms and control terms.

Economic Terms

Economic terms set out the price of shares, the investment amount and the rights and obligations of the newly created preferred share class.

SHARE PRICE AND VALUATION: The first part of the term sheet defines the offer made by the VC in a given round, including the valuation of the company (pre-money), amount of invested capital, number of shares to be issued and price per share. The type of securities to be issued for this round, for example "series B preferred stock," is clearly defined.

LIQUIDATION PREFERENCE: This clause gives preferred shareholders preference over any distributions received in case of a defined liquidity event, be it an acquisition by a strategic buyer, a merger, an initial public offering (IPO) or the liquidation of the company. Preferred shareholders receive their invested capital back first (and at times a multiple thereof) before any distributions are made to common shareholders. In the case of "participating preferred shares," preferred shareholders will share the balance of the exit proceeds after the liquidation preference has been satisfied pro rata with common shareholders, on an as-converted basis.

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP): An ESOP sets aside a percentage of shares in the start-up that can be granted to non-founding employees in the form of stock options to attract, reward and retain first-rate talent. A term sheet will stipulate a vesting schedule for these options—a clearly defined timeline for the options to convert into shares—it will also allow the board to force a forfeit of these options under certain circumstances. In addition, the term sheet will

12. More information on deal documentation can be found in Chapter 10.

clearly define the number of shares reserved for the ESOP, and the strike price, timing and expiration date of the options. Given that ESOPs are a source of dilution for all existing shareholders, both the size and timing of an ESOP need to be carefully considered when planning to raise external funding. Many VCs will require an ESOP of 20% of the outstanding shares before closing a round.

ANTI-DILUTION: This provision protects earlier investors in the event of a "down-round" (i.e., a round of funding raised at a lower valuation than the previous round). With anti-dilution provision in place, the conversion price of the preferred share class will be adjusted downwards to the level of the new valuation; as a result, shareholders who invested at a higher valuation in earlier rounds will receive additional shares to maintain their ownership stake in the start-up and avoid dilution.

Common shareholders do not have such protective provisions and will be diluted. Anti-dilution clauses come in various degrees of severity, and founders are well advised to be aware of their impact.

CONVERSION RIGHTS: Preferred shareholders may convert at any time to common stock at their sole discretion; the conversion rate—at the outset usually 1:1 of preferred to common—is clearly defined in this clause. Investors will generally be converted from preferred to common shareholders at clearly defined trigger events, typically just prior to a sale or merger. In the event of an IPO, conversion of the preferred stock is usually automatic.

Control Terms

Despite being minority shareholders, venture investors typically request certain control rights to monitor the development of the start-up and influence important decisions.

BOARD REPRESENTATION: VCs will expect to be represented on the board of directors of the investee company. Whether it is one or two board seats with the respective votes or merely an "observer right" depends very much on the dynamics during negotiations. (An in-demand company courted by several venture investors may be able to negotiate lesser representation as a condition of investment.) Founders are well advised to have a clear board plan—defining the number of seats available to venture investors and those assigned to independent directors—before raising their first external round.

PROTECTIVE PROVISIONS: Venture investors usually receive voting rights on an "as-converted" basis equal to that of common shareholders. In addition certain actions may require the consent of the VC or approval of at least 50% of the preferred shareholders. These actions may include alterations of the certificate of incorporation, which would adversely change the rights, privileges and powers of the preferred shareholder, or approval of any sale of assets or mergers, or any changes to the number of preferred shares issued. Veto rights may apply with regards to specific events such as an IPO, new equity financing or increase in the ESOP and can extend to governance matters such as the right to approve the appointment of senior executives.

DRAG-ALONG/TAG-ALONG PROVISIONS: A drag-along provision gives the majority shareholder the right to force other shareholders to sell their shares in a third-party transaction. This provision enables the majority shareholder to sell out and achieve a clean break at exit. A tag-along provision provides minority shareholders with the right to sell their shares in conjunction with the majority shareholder in a third-party transaction, participating in any liquidity event pro rata.

TRANSFER RIGHTS AND NEW ISSUE RESTRICTIONS: The term sheet typically includes preemptive rights for share transfers and new issues, stating that the existing shareholders shall be offered any shares first in the case of an existing shareholder wanting to sell out.

INFORMATION RIGHTS: This provision clearly states which operational and financial information must be provided to preferred shareholders and when; the requested information usually includes at a minimum unaudited monthly and annual financial statements.

FOR THE FIRST-TIME ENTREPRENEUR
RAISING MONEY FROM VCs

First-time entrepreneurs often think that all VCs invest in great ideas and innovative companies across industries and at any time in their lifecycle. This is far from the truth; every venture firm has a very specific focus on verticals, technologies, geographies, and most important investment amounts or funding rounds. They are likely to pass on a great idea if it doesn't fit their focus or sweet spot; thus, entrepreneurs should carefully select those funds worthwhile approaching. Due diligence is crucial for both parties, and entrepreneurs should ask for references from past investee companies before selecting a VC fund. Speaking with those founders will give them a clear idea of the day-to-day reality of working with and accepting funding from the respective VC.

Beyond focusing on how to fund their start-up, founders also need to decide on the timing and size of the various rounds. Entrepreneurs must balance the need for raising capital from external investors with the requirement of giving up equity in the process.

Consider the hypothetical financing of a start-up shown in Exhibit 2.4 in which an entrepreneur raises four rounds of external funding, at progressively higher valuations, over a three-and-a-half-year period.

The above example brings up a number of issues for entrepreneurs to consider. First, as the valuation of the start-up increases, the entrepreneur is able to raise larger sums of capital in exchange for lower equity stakes in the company. The burn rate allows an entrepreneur to plan the amount of funding needed to achieve the next development milestone and to optimize the time between rounds. Finally, the entrepreneur's

Exhibit 2.4 Fundraising Considerations for Entrepreneurs

CHARACTERISTICS OF ROUNDS				CONSIDERATIONS FOR ENTREPRENEURS			
ROUND	POST-MONEY VALUATION (USD)	CAPITAL RAISED (USD)	EQUITY STAKE OF THE ROUND	BURN RATE (USD/MONTH)	FUNDING (MONTHS)	ENTREPRENEUR'S EQUITY STAKE	USD PER 1% EQUITY STAKE
SEED	2m	150k	7.5%	15k	10	92.5%	20k
SERIES A	12m	2m	16.7%	150k	13	77.1%	120k
SERIES B	25m	3m	12.0%	300k	10	67.8%	250k
SERIES C	75m	6m	8.0%	CASH FLOW POSITIVE	N/A	62.4%	750k

declining equity stake following each round of investment shows clearly the impact of dilution when raising external funding.[13]

Some founders question the merit of giving up substantial amounts of equity in return for venture funding. They often consider an alternative: growing the company organically without external funding by conservatively managing the early stage with their own capital and trying to quickly grow revenue. With the rise of the "lean start-up"[14] model (and the availability of low-cost funding sources, i.e., crowd funding), this alternative path has become a realistic option for certain business models.[15]

What Is a Venture Capitalist?

By Brad Feld, Managing Director, Foundry Group

One of the biggest mistakes entrepreneurs make is to assume that all VCs are the same. Over and over again I hear questions like "how do I raise venture capital?," or "how do I approach a VC?," or "what does a VC want to see in the first meeting?," or "now that I'm going to pitch a VC, what should I show them?" The answer—generically—is "I have no idea—WHO are you meeting with?" This usually gets the person's attention, at least a little.

There is no single archetype for a VC, or for a VC firm. Instead, each VC, and firm, is different. Consider the game Dungeons & Dragons (or, if you don't know D&D, contemplate one of the *Lord of the Rings* movies.) Some VCs are elves, some are orcs, others are wizards, or mages, or trolls. Each character has a different set of skills, weapons, money, and experience points, which change, increase, and evolve over time.

13. Note that not only the entrepreneur gets diluted by subsequent financing rounds but also previous investors.
14. Reis, E. (2008).
15. Wasserman, Nazeeri, and Anderson (2012).

There are dozens of archetypes of VCs. Each individual VC has a different set of skills. Their styles, beliefs, and personalities vary widely. Their approaches and ideas are influenced by the individual's historical experiences. Behavior—both in the moment and over time—varies widely.

A VC firm is a collection of individual VCs with differing archetypes. Firms vary widely in shapes and sizes. My firm, Foundry Group, consists of equal partners and no additional professionals. Other firms have many layers of investment professionals, including partners, principals, associates, analysts, entrepreneurs-in-residence, and operating partners. Some VC firms are small—there are even single partner firms—while others have dozens of investment partners. Some firms are operator heavy (partners with operating backgrounds), others are financial heavy (MBAs and bankers), while others are a mix.

The entry points of VC firms vary widely. Some VCs invest early. Others invest late. You have firms that label themselves as pre-seed, while others call themselves seed and early-stage investors. Other firms wait until a company is in the market with a product that is starting to scale. Other VCs, often called growth investors, prefer to engage when a company is clearly succeeding and is now scaling. Still others like to be the last round investor prior to an IPO and are consequently called late-stage investors. And yes, there are firms that cut across multiples of these categories.

The categories that firms invest in, and how they describe them, also vary widely. Foundry Group uses a thematic approach that we pioneered in 2007. Other firms use a sector approach, which has been around for many years. Some firms invest only in software and Internet-related companies, while others invest in clean tech or life sciences. Once again, the configuration of the approaches can be combined in many different, and occasionally unique, ways within a VC firm.

Once you realize you are dealing with many different archetypes of individual VCs with widely varying skills and experience levels, and the configuration of these archetypes into a firm is similar to how characters combine and interact in a battle in D&D, you realize that there is no generic VC or VC firm.

As an entrepreneur, you should do your research on the person and firm you are approaching or talking to. It's easy to do today using the web and the power of all the network connections between people. If you understand who you are talking to, what motivates them, and what they care about, you can both target them better as well as have a much more effective conversation with them.

Box 2.3

BEYOND VENTURE CAPITAL

ALTERNATIVE PATHS TO FUNDING

VC funds are not the only source of capital for start-ups. A variety of players provide capital and expertise to these businesses, each with a different set of value propositions. Early-stage companies may work with several of these players and VC investors to get their business off to a successful start.

BUSINESS ANGELS: Angel investors are affluent individuals who invest their personal funds at a very early or "idea" stage of development. They are often experienced professionals from the industry in which the start-up operates and may be closely involved in shaping and developing the company's first business plan.[16]

START-UP INCUBATORS AND ACCELERATORS: These vehicles help start-ups develop and grow their businesses.[17] Particularly first-time entrepreneurs may find the structure, support and mentorship offered by these programs attractive. Admittance into the best programs is highly competitive, with some accepting no more than 10 candidates per 1,000 applicants. Incubators and accelerators are often mentioned in the same vein—but there are differences:

- Incubators: Incubators guide entrepreneurs through the first steps of idea generation and help them develop a business model on the basis of that idea. These programs have no set duration and typically provide office or co-working space, administrative support and networking opportunities to entrepreneurs in exchange for rent or—in some instances—an equity stake in the start-up. Incubators are often sponsored by a government entity or university and generally do not provide capital.
- Accelerators: Accelerators offer short, intense courses and access to industry mentors for entrepreneurs that have a proven concept and are ready to consider raising VC financing. Accelerators admit start-ups in cohorts and each program culminates in a "demo day" when participants pitch their investment idea to a group of potential investors. Most accelerators are privately owned and often provide a small amount of seed funding in exchange for an equity stake in a participating company.

CORPORATE VENTURE CAPITAL: Corporations have emerged as a fast-growing source of funding for start-ups and compete head-on with independent VC funds. Corporate venture capital (CVC) is created by business entities not usually engaged in financing and investing; INTEL Capital, Unilever Ventures and Google Ventures are among the most prominent. These investors often

16. Please refer to the links and references at the end of this chapter for additional material on angel investors.
17. Readers will find a list of incubators and accelerators on our website (www.masteringprivateequity.com).

leverage the expertise of their parent organizations and invest in industries where the parent is active. The main incentive to start a CVC program is to gain early access to disruptive innovations that may help (or hinder) the strategic goals of the parent company, with financial returns often a secondary consideration.

CLOSING

Fast-growing companies, incubated around a creative idea on how to solve a problem or explore an opportunity, are not a coincidence. Big successes require a meeting of minds between a skilled founding team and investors providing funding and mentorship to offer advice if and when needed. This chapter offered perspectives from both sides of the table, considering investors and entrepreneurs alike. The magic in the form of big disruptions and extraordinary returns happens when talented entrepreneurs meet the best-suited venture partners.

KEY LEARNING POINTS

- **VC funds invest minority stakes in start-ups seeking to develop defensible, fast-growing businesses by disrupting existing products and services through innovation.**
- **VC investing is characterized by tail-end returns, with one or two home runs typically offsetting the failed investments in a successful fund.**
- **VC funds invest in specific industry verticals and stages of company development, from seed to early to late stage.**
- **Entrepreneurs must be aware of the trade-offs between accepting external funding and giving up equity when raising capital from VC funds.**
- **Understanding the future impact of the terms negotiated during fundraising is key, especially for first-time entrepreneurs.**

RELEVANT CASE STUDIES

from *Private Equity in Action—Case Studies from Developed and Emerging Markets*

Case #5: Sula Vineyards: Indian Wine?—Ce n’est pas possible!

Case #6: Adara Venture Partners: Building a Venture Capital Firm

Case #7: Siraj Capital: Investing in SMEs in the Middle East

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GROWTH EQUITY 3

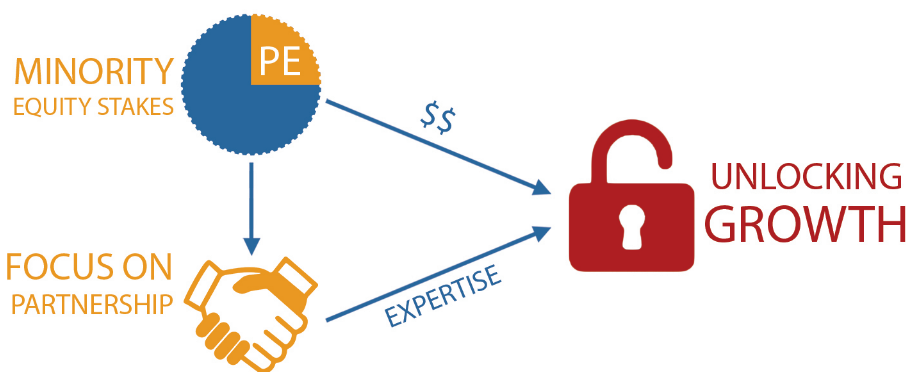
Growth equity funds occupy the space between (and thus complement) venture and buyout investing, providing fast-growing but established businesses with funds and support for a transformational leap in their development. Growth equity accounts for the largest number of private equity (PE) deals executed in emerging markets. In addition, following the global financial crisis, growth equity investments have gained fresh momentum in developed markets, as they provided an avenue to deploy capital at a time when debt markets were closed.

This chapter explores the strategy's defining traits, describes the attributes of its target companies and the unique characteristics of the growth equity investment process. We conclude with a closer look at some of the minority shareholder rights sought by growth equity investors.

GROWTH EQUITY DEFINED

Growth equity funds invest in fast-growing businesses (which have moved beyond the start-up stage) in exchange for a minority equity stake. Given the lack of control, a strong working relationship and trust-based partnership between the investors, existing owners, and management are required to achieve the desired outcome: advancing the company to a new stage of development. These dynamics are shown in Exhibit 3.1.

Exhibit 3.1 Defining Characteristics of Growth Equity



MINORITY EQUITY STAKES: Growth equity investments are usually made in exchange for a minority equity stake; strategic and operational control of the company will remain with its existing business owners. A growth equity fund's stake in a business typically consists predominantly of newly issued shares, although a portion of funding may be used to provide an exit for existing business owners. Only a small subset of growth equity deals results in the PE firm acquiring more than 50% of a company's equity and benefiting from the ensuing majority shareholder rights. In these instances, the key aspect differentiating growth equity from control buyouts is the active role both founders and management teams retain in the company.

The minority equity position of an incoming PE investor shapes all aspects of the investment process, from deal structuring and operational decision-making during the holding period, to the course of action at exit. From the outset, it is important for minority investors to understand the motivations of the majority shareholders and ensure they are aligned with the fund's investment thesis, its base case scenario for expansion and its plans for change. Still, focusing on an agreed-upon plan and executing the necessary changes can prove quite challenging from a minority position, even with a good working relationship and appropriate minority shareholder rights in place.

FOCUS ON PARTNERSHIP: In an ideal scenario, owners, existing management and new investors will form a successful partnership contributing complementary skills that help obtain superior operating results at the portfolio company. Growth equity investors bring financial acumen to the table, in particular experience in optimizing capital structures, in buying and selling businesses, and familiarity with capital markets and the initial public offering (IPO) process. In addition, they often have a broad network in both commercial and financial circles and experience in creating corporate governance structures in line with global best practices. Overall, their skillset can be an effective complement to the operating knowledge and local networks developed by owners and management.

As growth equity does not primarily provide liquidity to the owners, the economic interests of both parties are well aligned. Furthermore, it may be in the PE firm's best interest to keep the existing management in place and in control, as they have a working knowledge of the operating business and its markets. A growth equity investment will therefore often be minimally disruptive to the operating dynamics of a business, since existing relationships between owners, management, suppliers, customers and other stakeholders are maintained.

To ensure a smooth working relationship, both parties need to agree on growth and development targets and align their interests from the start. A clear understanding of the culture and approach to business at both the PE firm and the target company can help manage expectations and set realistic rules of engagement for both parties. PE investors and existing company owners must each carefully select partners that complement their individual investment and management styles. For example, a hands-on active investor may be best advised to avoid investing in a "closed" family business, and a passive investor might not be the right partner for a business with urgent restructuring needs.

UNLOCKING GROWTH: Growth equity funds invest in established businesses with proven business models and attractive future prospects for expansion. Portfolio companies often operate in expanding economies, in sectors exceeding a country's average national growth, or in industries ripe for disruption. A growth equity fund's capital, its industry and operational know-how can provide a company with the resources to unlock latent potential, improve profitability and enable accelerated growth.

The capital invested by a growth equity fund is typically used for two purposes:

- To fund specific, value-accretive projects at the portfolio company. Growth equity firms often employ a bench of operating partners who can help define these projects and drive the value creation process. Incoming funds may be used, for example, to realize international expansion plans, develop a new product line, fund working capital to reach scale, expand existing facilities, or consolidate a fragmented industry through roll-up acquisitions. Companies should select their preferred growth equity partner from a group of suitors based on their experience in driving the specific initiatives needed to maximize value creation.

- To provide liquidity to the current owners and founders and help simplify its shareholding structure. The latter can help reduce the complexity of economic claims on a company and significantly simplify the governance process. The new investor may, for example, replace a number of venture capital (VC) investors from earlier investment rounds in a successful start-up or step into the shoes of a group of family members in a family-owned business.

Creating Value through Genuine Partnerships

By J. Frank Brown, Managing Director and Chief Operating Officer, General Atlantic

Partnership is a frequently overlooked cornerstone of successful growth equity investing. Many fast-growing businesses are at an inflection point in their development, in need of a candid, patient, and strategic partner to help them manage and accelerate their growth by seizing new opportunities, mitigating risks, and preparing to scale their business models. The most important aspect of any partnership is the alignment of interests; if an investor and investee work together to build a successful company that is designed to scale and grow—the holy grail of growth investing—both will be successful.

In order to unlock maximum value and drive superior returns, an investor needs to build a genuine partnership with entrepreneurs by using a relationship-focused approach founded on an alignment of interests. But what makes a partnership genuine? What components are needed to maximize the success of a growth investment?

- Transparency and mutual understanding. With fast-growing companies, there needs to be agreement on a host of factors related to a company's current and potential future growth trajectory, including: how fast the company can grow, how it will expand, what capital is needed for that to happen, who is the optimal management team to lead that growth, and much more. In our experience, people are the most important factor determining a company's success, which means having the right leadership and employees in place as quickly as possible is critical.
- A short- and long-term plan. The investor and company management team also need to agree on a plan for the first year of the investment, as well as a longer-term plan, including how to prepare the company for its next phase of growth in the coming decade. Is the company going to expand to other markets, and to other products or services? How will the business need to grow in terms of its employees and management team? What capabilities are needed that don't currently exist at the company and does it have the right in-house talent to lead those capabilities effectively?
- Ongoing engagement. An investor needs to remain engaged over the lifecycle of the investment, with the investment team continuing to work hand in hand

with the portfolio company over the entire period of ownership, instead of passing off responsibility once the deal has closed. They should connect the portfolio company to the impactful advice, relationships, and resources it needs to enable and sustain growth. One of the most important roles of a growth investor is serving as a sounding board to entrepreneurs, offering guidance and best practices in all aspects of the business, including human capital, revenue generation, and operational excellence. To do this effectively, an investor needs to build and leverage a global network of relationships to help growing companies draw from best practices across industries and regions, and build a world-class leadership team and board that will help them scale.

- A structure-reinforcing partnership. A growth equity firm's investing structure should be geared toward alignment with its portfolio companies. For example, we generally invest in common stock with a simple liquidation preference that provides protection without overly structured provisions. To engrain an ethos of partnership and collaboration in a firm, investment teams need to be incentivized to add value and harvest gains, not put money in the ground. For example, our collective team represents the single largest commitment in our capital base. Our team members put their own money into every deal that we do, creating the ultimate alignment of interests. This motivates everyone to help build a successful enterprise from the time we finalize negotiations with a company and fund the capital until the time we exit the investment.
- Engagement across geographies. If a growth equity firm has a global footprint, the optimal incentive structure will rally team members around the globe to help a company unlock value and drive growth across geographies—critical for the many growth companies that rank global expansion as one of their chief objectives. While many global private equity firms have separate geographic funds with separate economics, motivating their investment teams to focus solely on deals within their region, at General Atlantic, we channel our communal focus on global growth equity. We have a unique global carry pool so team members benefit—and thus are ready and willing to help a portfolio company succeed—regardless of where a deal is done and who does it.

By building a transparent, aligned, and enduring partnership with a rapidly growing business, a growth equity investor is in a unique position to serve as a steady co-pilot, helping it stay on course and rise to new heights—and, by doing so, generate value and maximize returns.

GROWTH EQUITY TARGETS

Growth equity funds invest predominantly in three types of businesses: late-stage venture capital-backed companies, mature small and medium-sized enterprises (SMEs), and spin-offs from large corporations. These companies typically have high capital expenditure and increased working capital requirements to sustain their growth trajectory. Their investment requirements leave little free cash flow to service debt and the scale of company operations often inhibits their ability to tap public equity markets. As a result, an infusion of PE growth equity can be an attractive way to fund incremental growth. We explore the three types of target companies below.

LATE-STAGE VENTURE-BACKED: Growth equity is a crucial ingredient for VC-backed companies that have established a successful business model, claimed a defensible market position and reached profitability in their steady-state operations. Having arrived at this stage, these post-revenue and post-profit companies require access to deeper pools of capital to scale their activities and execute secondary or tertiary growth strategies. Thus, engaging with a growth equity fund clearly marks the transition from a start-up to a robust, sustainable business. Like VC funds, growth equity funds may continue to deploy capital into these companies over several rounds of investment and may over time establish a path to a controlling stake.

MATURE SMEs: Mature businesses with a unique competitive advantage and attractive development prospects offer perfect opportunities for growth equity investment. These companies often possess a strong market position with a well-recognized brand and a solid network. Investments from a growth equity fund frequently represent the firm's first and only engagement with a financial investor. As SMEs are in many cases family businesses or entrepreneur owned and controlled, a minority investment allows these owner/managers to maintain control of the board and the company's day-to-day operations. This differs from a successful late-stage VC-backed company, where founding entrepreneurs have typically given up significant equity and governance rights in earlier fundraising rounds.

SPIN-OFFs: Growth equity investors at times target divisions of large corporations that are well positioned for divestment or spinoff. In these instances, a corporation will typically retain control of the division initially but add capital and know-how from the PE investor to spark growth and pave the way for a smooth handover to a new investor (including public market) when the corporation eventually decides to step out. These targets are often inadequately resourced from a funding and talent perspective and thus offer greater upside under a new ownership and governance structure outside the parent entity.

Box 3.1

GROWTH EQUITY IN EMERGING MARKETS

As mentioned earlier, one aspect of growth equity investment is its prevalence in emerging markets. Observers of PE are often surprised to note that more than three-quarters of the PE deals in emerging markets are minority investments into mature SMEs. The reason: the majority of attractive companies that have thrived during the rapid economic development in these markets are family-owned businesses, still managed and controlled by the first or second generation of families. These founders are often reluctant to give up control of their company. Yet, after decades of rapid growth the foundations of these businesses are often lacking and governance structures are in need of a revamp. An experienced growth equity fund can help reform and professionalize the board, bring in experienced senior and middle management and help the firm think through suitable levers to ensure success for future generations.

THE GROWTH EQUITY INVESTMENT PROCESS
UNIQUE ELEMENTS

The typical growth equity investment process is distinct from other forms of PE investing. From deal sourcing to value creation to exit, understanding the needs of a growth company requires a specific skillset.

DEAL SOURCING AND DUE DILIGENCE

Identifying targets for growth equity funds can be a challenge: minority investment opportunities in mature SMEs are less intermediated than control deals and the most attractive target companies rarely seek an infusion of capital from external investors. Sourcing growth equity deals therefore requires a strong proprietary network; it can take years to build a relationship with company owners, argue the case for investment and eventually consummate a deal. Often these businesses do not explicitly need capital to maintain their current operating model, shifting the onus to the growth equity investor to open doors and convince company owners of the opportunities that an infusion of external capital can unlock.

Once a suitable target is identified, the lack of robust monitoring and reporting structures at many growth equity targets can introduce a significant information gap between existing owners and new investors, placing PE firms at a disadvantage during due diligence, valuation and negotiations. For investments in highly visible late-stage VC-backed companies, the challenge is slightly different: competition from multiple growth equity funds can accelerate the capital-raising process, but require investors to make decisions quickly with incomplete information, and accept valuations or terms driven by competitive dynamics or market momentum.

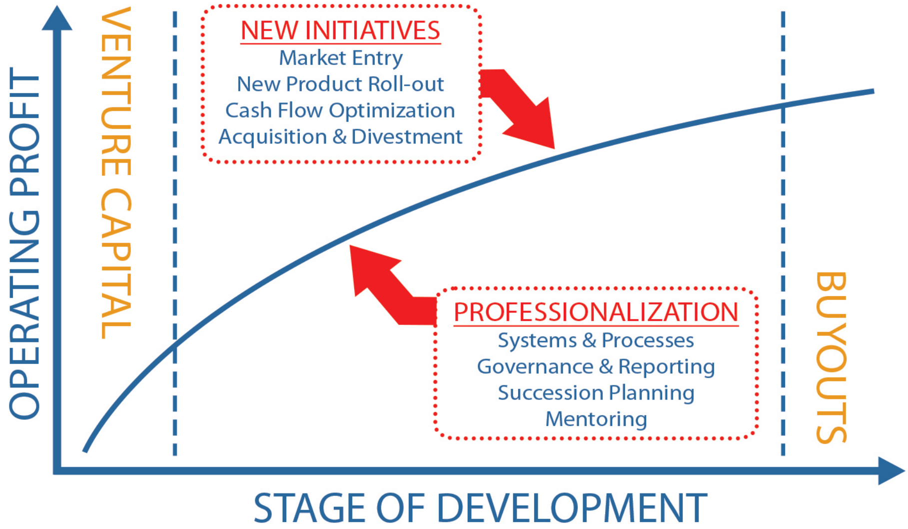
Negotiating growth equity deals can be particularly challenging given the presence of strong entrepreneurs and founders, as decisions often hinge on non-economic interests that may be difficult to identify for an outside party. The pre-investment phase is nevertheless the time when PE investors have the best chance of shaping a company's strategy by convincing management of its expertise and influencing shareholding terms given their position as prospective new capital providers.

Finalizing and executing growth equity deals is typically easier than in more complex buyout transactions; the lack of leverage and the smaller number of parties involved makes negotiation, information gathering, vetting of documentation, and closing the deal significantly easier.

VALUE CREATION

Whether a mature SME, a VC-backed company or a corporate spin-off, growth equity portfolio companies share similar levers for value creation. As growth equity investors rarely employ debt to magnify returns on their equity stake, their focus will be on driving change at the operating company (through strategic, operational and

Exhibit 3.2 Value Creation in Growth Equity



financial initiatives), or professionalization and governance optimization, as shown in Exhibit 3.2[1]

Professionalizing governance and business processes provides the necessary backbone to execute value creation initiatives. Given the initially lean set-up of VC-backed companies and the resource constraints in SMEs, many of the structures and processes governing their business operations and decision-making have previously been implemented in an ad-hoc fashion. Therefore, improving reporting structures and information flow, and professionalizing the management of both human resources and capital is essential for these companies to consolidate their advantage and enable the next stage of growth. PE investors can add value by mentoring current management and identifying blue-chip talent to help with succession planning. In addition to the PE firm's network, the presence of a new and committed shareholder sends a strong signal to the market, which may attract talent to the company.

When working with owner-operators, PE investors must be realistic about the number of changes they can implement during the holding period. While contractual rights can reassure and protect the investor's interests, the ability to execute controversial restructuring and cost-cutting plans will likely be constrained by the fund's minority equity position.

EXIT

Similar to most PE investors, growth equity funds will target to exit their investments within three to seven years. While the company may have grown in line with the business plan, finding a buyer willing to step into the shoes of a minority shareholder can be difficult. At times, the majority owner may exit alongside the growth equity fund, providing a viable acquisition target to strategic investors, who usually require a control stake in a business; however, these cases are the exception rather than the

1. Please refer to Chapter 13 Operational Value Creation for further insights into the tools used by PE firms to improve their portfolio companies during the holding period.

rule. More likely, the growth equity stake will be sold on its own, for instance via a secondary sale to another PE fund or a buyback by the entrepreneur.

Large portfolio firms may choose the IPO route, allowing on the one hand the owner to maintain a controlling stake and on the other hand the PE investors to sell down their holdings during or after listing. A similar mechanism applies for private investments in public equity, a common structure for growth equity funds in certain jurisdictions; given the company is already listed, the growth investor can sell into the public market upon exit.

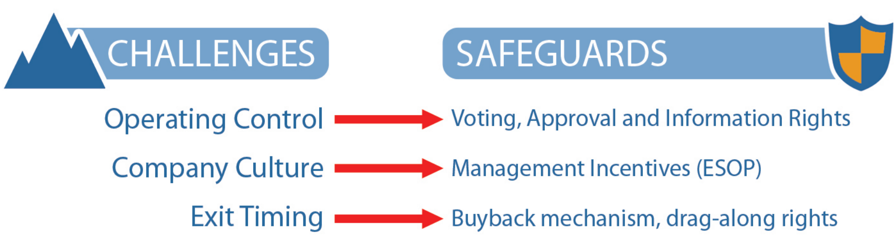
Disagreements between the multiple shareholders can complicate the exit process. A mismatch in valuation expectations or non-economic priorities such as job preservation for family members or the protection of the company heritage can confound the exit process. In addition, a PE firm may be unable to optimally prepare the portfolio company for the sale of its stake from a minority position. Clarifying possible exit avenues early on and drafting the necessary documentation to ensure both parties are aware of and aligned with future plans are important to mitigate these risks and reduce conflicts.

MINORITY SHAREHOLDER RIGHTS

To mitigate the risk associated with minority ownership, growth equity investors negotiate explicit shareholder rights to monitor their investee firms, influence company proceedings, and preempt or mitigate potential conflicts of interest with the majority shareholder. Explicit rights and safeguards are included to ensure that the investor's interests are clearly expressed and aligned with those of the company's owners. Contractual provisions may be included to enable enforcement; they are negotiated as early as the submission of a letter of interest or term sheet and later formalized in an amended company's shareholder agreement post-investment.[2] Exhibit 3.3 shows some of the mitigating contractual safeguards employed by minority investors.

A jurisdiction's regulatory code and its established case law provide an important safety net for minority shareholders to mitigate the risk of unfair treatment, or ensure the enforcement of their rights. The investor may petition a court, stating that majority shareholders have run the company in a manner unfairly prejudicial to the minority shareholder; examples include not sharing financial information in a timely manner, dealing with associated companies on a non-arm's length basis or

Exhibit 3.3 Minority Shareholding Dynamics



2. For further details on the process and documentation of PE transactions please refer to Chapter 10 Transaction Documentation.

gross incompetence of senior management (or a family member). The court may then ask the controlling shareholder to refrain from certain activities, authorize civil proceedings or order the minority stake to be acquired by the controlling shareholder.

OPERATING CONTROL: The governance terms associated with growth equity investments vary widely, but typically include representation on a portfolio company's board of directors and certain negative control and approval rights. Growth equity investors may also seek voting rights disproportionate to their ownership share to strengthen their ability to execute strategic and operational change and prepare the company for a successful exit. Negative control and approval rights provide growth equity investors with control over decisions related to operating and capital budgets, C-level executive changes, mergers and acquisitions and divestment activity, new borrowing and equity issuance, divergence from strategic plans, and expansion into new business lines. Information rights ensure that accounts and advanced notice of important corporate actions are disseminated in a timely fashion. Overall, these contractual provisions provide growth equity investors only with the means to block company activities detrimental to their interest, underscoring the importance of developing a productive working relationship with business owners to drive value creation.

MANAGEMENT INCENTIVES: Given their limited operating control, growth investors strive to boost alignment with management through financial incentives. A management share or option plan tied to key operating and financial metrics will focus the manager's attention on growing the business in line with investor's goals. Ideally, shares should only vest upon exit of the PE fund to match the investor's time horizon. An incentive plan will often constitute a requirement to attract higher-caliber talent to professionalize management and drive the next phase of growth in the company.

LIQUIDITY: As minority investors, growth equity funds lack the voting rights to force the hand of majority owners at exit time. Some of the contractual provisions that protect their interests include put options that allow a fund to sell its stake back to the controlling shareholders at a predetermined minimum price or, in the case of severely missed performance targets, the ability to initiate a liquidity event such as an IPO. They may also include drag-along rights that enable the investor to force the remaining shareholders to participate in the sale of the business.

CLOSING

Growth equity has developed into a recognized strategy within the PE industry. In many instances and particularly in developing markets, where businesses are often owned and managed by the first or second generation of families, minority investors are much sought after, especially when they come with relevant industry expertise and the ability to open doors to new (overseas) markets. Given their reliance on strong partnerships and cooperation with the founding families, it is no surprise that successful PE firms take specific care to develop lasting relationships and a solid reputation with the business communities at large. In the day and age of ample dry powder, it is no secret that even traditional buyout funds have expanded their investment strategy to include minority investments in order to deploy capital in a timely manner.

KEY LEARNING POINTS

- **Growth equity funds invest in fast-growing, established companies in return for a minority equity share and make a concerted effort to establish a solid partnership with all company stakeholders (especially majority owners).**
- **Beyond capital, growth equity funds offer hands-on involvement with their portfolio companies to assist with business development, professionalization and expansion.**
- **Minority protection rights are crucial for growth investors especially with regards to achieving a successful future exit.**

RELEVANT CASE STUDIES

from *Private Equity in Action—Case Studies from Developed and Emerging Markets*

Case #7: Siraj Capital: Investing in SMEs in the Middle East

Case #8: Private Equity in Emerging Markets: Can Operating Advantage Boost Value in Exits?

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BUYOUTS 4

From the earliest modest takeovers of the 1960s to the mega-deals of recent years, buyouts have accounted for the majority of the capital invested globally by private equity funds. Racking up both spectacular successes and headline-grabbing failures, buyout firms have been viewed with either admiration or trepidation by investors, governments, regulators, and the media.

The public perception of buy-out transactions is cyclic; waxing and waning with the prevailing macroeconomic environment or one's ideological position. However, control transactions undeniably provide the levers to radically re-engineer a business and drive change across all aspects of an investee company. And they can measurably impact the economy at large.

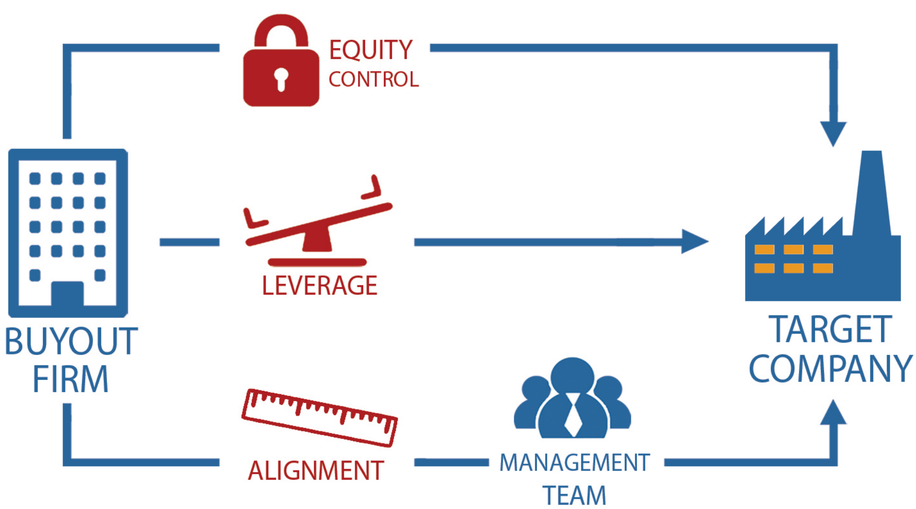
This chapter first defines the three essential components of a buyout and then analyzes a typical funding structure in leveraged buyouts (LBO).[1] It goes on to examine the principal stakeholders in various types of buyouts and concludes with an overview of the common buyout strategies.

BUYOUTS DEFINED

Buyout funds acquire controlling equity stakes in companies that allow them to restructure the targets' financial, governance, and operational characteristics. However, despite this control element, buyout investors must work proactively with a wide range of stakeholders—from management to debt providers—to execute on their investment thesis by driving value creation in their portfolio companies.

Three components define a buyout strategy: equity control, leverage and economic alignment. Each of these levers, shown in Exhibit 4.1, provide buyout funds with ways

Exhibit 4.1 Defining Characteristics of Buyouts



1. For the sake of simplicity, we will use the terms "LBO" and "buyout" interchangeably.

to influence strategic and operational decision-making at the target to maximize their return on investment.

EQUITY CONTROL: In a typical buyout, the PE fund will control a majority of the economic and voting interests in the portfolio company. A controlling interest does not necessarily imply 100% ownership of shares—in fact, in certain circumstances it may even be less than 50%—but rather that the buyout fund has the right to dictate strategic and operational decisions via the board of directors. In the case of a minority stake, de facto control can be obtained through a coalition of like-minded investors or specific provisions in the shareholders' agreement.

Control allows a buyout fund to apply leverage to a company's capital structure, expand or replace a portfolio company's management team, restructure its governance and reporting structures, drive operational improvement, and professionalize the overall business throughout the holding period. Control is crucial when it comes to exit planning, as buyout investors can initiate the necessary governance upgrades, ensure strategic alignment and authorize additional spending if and when required to optimally position the investee company for sale.

Given those advantages, acquiring a controlling interest in a company frequently commands a higher price ("control premium"), especially in the case of take-private transactions of publicly listed companies.[2]

LEVERAGE: Most buyouts are structured as LBOs, with a significant portion of the transaction financed through debt. A portfolio company's capital structure post-buyout will typically consist of 50–75% debt, with equity funding the balance.[3] The debt capacity of a target is a function of several factors, including the stability of cash flows across an industry, the target's ability to generate cash flow from operations (i.e., its cash conversion rate), market conditions and the buyout investor's reputation (i.e., as a borrower in earlier deals). During the investment process, buyout funds analyze a range of operating scenarios to optimize the amount of leverage applied in a transaction, thereby considering various downside scenarios and ways to reduce the risk in an investment.[4]

Assuming a fixed purchase price, the primary benefit of leverage is the ability to achieve higher returns on the buyout fund's equity stake. Leveraged capital structures increase an investor's return on capital by reducing the amount of equity required to fund its transactions. However, due to the competitive nature of most sales processes, the benefit of a leveraged transaction accrues to a large extent to the seller, as it allows the buyer to offer a (higher) purchase price that would be impossible to reach without debt.

So while the benefits (mostly) remain with the seller, the buyer faces the other side of the coin, namely, the increased cost and strong cash flow required to service the debt (both annual interest payments and debt repayment). These obligations make the

2. Please refer to Chapter 8 Deal Pricing Dynamics for additional information on deal pricing and public-to-privates.

3. The original buyout transactions in the 1980s employed higher leverage ratios, sometimes as high as 90% or more. As the PE industry matured, the amount of leverage applied in buyout investments dropped and settled at a generally lower level. In some jurisdictions new regulations have made the use of leverage beyond a certain point less economical.

4. Please refer to Chapter 7 Target Valuation for additional information on optimizing the funding structure in a buyout.

portfolio company more susceptible to external shocks, thereby increasing the risk of financial distress or even bankruptcy.

The impact of a highly leveraged capital structure is not entirely negative: the increased risk of financial distress following an LBO has been shown to have a disciplining effect on management. Debt servicing requirements reduce the free cash flow available for capital investment and force management to prioritize high net present value projects.[5]

Finally, the covenants associated with debt financing introduce a monitoring and early warning system to identify lapses in company performance. The breach of a covenant triggers a range of remedies to protect the debt holders' economic claim on a portfolio company, giving them an opportunity to take action before the viability of the business is at risk.[6]

ECONOMIC ALIGNMENT: The ability to align the economic interests of its portfolio company's management team with that of its fund is a key driver of PE's success in buyouts.[7] The management compensation plans used provide senior executives with meaningful equity stakes in the target company and substantial upside in the event of a successful exit. These plans typically require a significant personal co-investment from each participating executive. With managers participating in a buyout as owners, a PE fund's goal of maximizing financial return is thus shared by those in charge of executing the fund's investment plan and managing the day-to-day operations at the portfolio company.

While the structure of these compensation plans magnifies management's potential returns on the upside, it comes with risks. A management team's "sweet equity" and stock options produce a return several multiples of that realized by the PE fund, should an investment perform as planned. However, in the case of a poorly performing business, management's co-investment is at risk of being wiped out, as their equity stake is often subordinated to that of the PE fund. In such a scenario, the PE fund's equity stake will typically retain some value and claim 100% of the proceeds to equity shareholders given its preferred position in the capital structure.

LEVERAGED BUYOUT FUNDING

In an LBO, buyout investors combine their fund's equity capital with debt capital raised from a range of lenders to acquire a target company.[8] While the specific instruments employed vary deal by deal, typical LBO financing consists of senior debt, junior debt and equity capital.

5. Debt has been found to make managers risk averse in the face of bankruptcy risk.
6. Please refer to Chapter 9 Deal Structuring and Chapter 10 Transaction Documentation for further details on bank financing and covenants.
7. Please refer to Chapter 12 Securing Management Teams for a detailed example of management incentive structures.
8. Please refer to Chapter 9 Deal Structuring for additional detail on LBO debt instruments.

Exhibit 4.2 Sources and Uses of Funds in a Buyout

SOURCES		USES	
Senior Debt	450.0	Purchase Target Equity	550.0
Junior Debt	200.0	Refinancing Net Debt	430.0
Equity	350.0	Transaction Costs	20.0
Total Sources	1,000.0	Total Uses	1,000.0

The capital is used to fund the acquisition of the target company's equity, repay a target's existing net debt and cover fees and expenses associated with the acquisition. Exhibit 4.2 shows a simplified example of the sources and uses of funds in a buyout.

SENIOR DEBT: Senior debt is typically issued by one or more banks and represents the largest portion of debt raised for an LBO. This class of debt is the least expensive source of long-term financing as it has a priority claim on the company's assets in case of bankruptcy; it is typically "secured" against specific company assets, further strengthening senior debtholders' bankruptcy rights. It typically has the shortest term (five to eight years) among all debt instruments, pays an annual cash coupon and comes with the most stringent debt covenants in the capital structure. Senior debt is often raised in multiple tranches, one of which is amortized through annual repayments (with any balance due at the end of the loan's term); the remaining tranches are repaid in a single bullet payment at maturity.

JUNIOR DEBT: Junior debt accounts for the remaining debt capital in a buyout; the most common forms are mezzanine financing raised in the private institutional market and high-yield bonds raised from the public bond markets. This layer of debt is unsecured and subordinated to senior debt in the event of bankruptcy. Junior debt instruments have longer maturities than senior debt (eight to ten years), pay annual cash interest and may in some cases accrue additional non-cash interest; they are typically repaid via a single bullet payment at the end of the term.

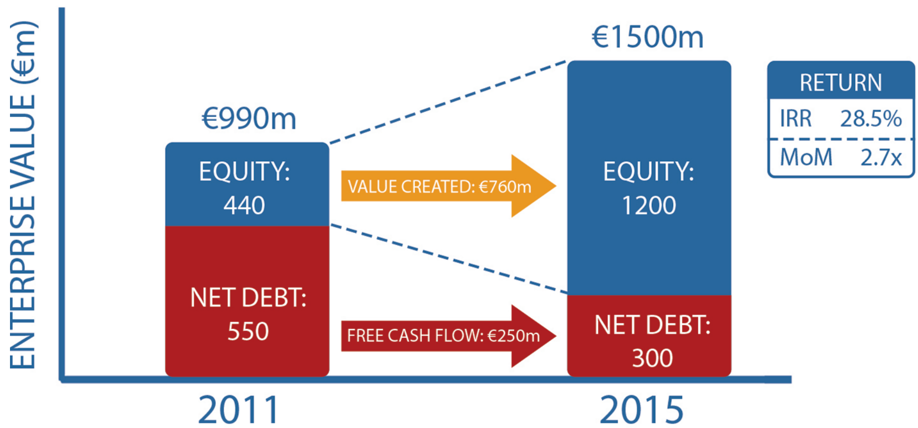
EQUITY CAPITAL: Equity capital typically accounts for 25–50% of LBO funding. The equity portion of a buyout may be sourced from a single buyout fund or a consortium of funds, management team members, and LP co-investors. Equity is the most junior funding instrument, with only a residual claim on operating cash flow and company assets in the event of bankruptcy or restructuring. The equity in a buyout is often divided into a preferred share class or shareholder loan (typically accounting for the majority of equity capital invested), and common equity. A PE fund will usually hold the vast majority or all of the preferred shares, while management will own a significant portion of the common equity.

Box 4.1

BUYOUT VALUATION AND VALUE DRIVERS

This example explains the mechanics of a “standard” LBO and illustrates value creation at both the company and equity level. It shows how returns can be broken down and attributed to the various basic value drivers in a buyout[9] (Exhibit 4.3).

Exhibit 4.3 Buyout Valuation and Return



ENTRY		EXIT
€110m	EBITDA	€150m
9x	EV MULTIPLE	10x
5x	DEBT MULTIPLE	2x

Let’s assume a PE fund acquires in 2011 a company with €110 million in earnings before interest, tax, depreciation and amortization (EBITDA). The purchase price (enterprise value) has been negotiated and agreed to be €990 million, representing a multiple of 9× EBITDA. As typical in an LBO, a substantial amount of the purchase price is financed by debt, about 5× EBITDA or about 55% of the purchase price, while the remainder is paid for with equity.

Over the next four years, the company grows its EBITDA at an annualized rate of about 8% to €150 million. Crucially, over the same period, the company generates €250 million in free cash flow (after investment and after financing cost) allowing the owners to repay some of the debt.

With a better performing company at hand (and maybe with the benefit of a generally improved economic climate) the PE fund is able to sell the company at a multiple of 10× EBITDA in 2015. After subtracting the remaining debt from the enterprise value of €1.5 billion, the value of the equity amounts to €1.2 billion or 2.73× the invested capital. For a holding period of four years, this equates to an internal rate of return (IRR) of 28.5%.[10]

9. Please refer to Chapter 13 Operational Value Creation for more on attributing operational value-add.
10. The simplified calculation does not include transaction cost on entry or exit.

It is worth noting that the enterprise value over this period has "only" grown at about 11% per annum, clearly demonstrating the effect of leverage on the returns in buyout deals. Overall, €760 million in equity value has been created, through the contributions of the value drivers shown in Exhibit 4.4.

Exhibit 4.4 Buyout Value Drivers

CREATED VALUE	=	EBITDA IMPACT	+	MULTIPLE IMPACT	+	NET DEBT IMPACT
€760m	=	€360m	+	€150m	+	€250m
(100%)	=	(47%)	+	(20%)	+	(33%)

In this case, 47% of the equity value came from EBITDA growth (calculated as [Exit EBITDA minus Entry EBITDA] × Entry Multiple), 20% from multiple expansion (calculated as [Exit Multiple minus Entry Multiple] × Exit EBITDA and finally 33% from net debt reduction of €250 million.[11]

A Differentiated Approach—Buying Right and Creating Value Early

By Andrew Sillitoe, Co-CEO, Apax Partners LLP and a Partner in the Tech & Telco team

There are two distinct approaches to LBO investing that can be seen in the market, firstly paying up for sustained growth and secondly an approach that can be referred to as "buying right and creating value early."

The first approach essentially offers only one value creation lever—EBITDA growth. This approach can lead to inflated entry prices, justified by ambitious, high-growth five-year business plans that forecast acceptable IRRs, but that often result in less reliable, back-end loaded returns. The high multiples paid, often when too much capital is chasing too few deals, mean buyers effectively spend the first two years, the most predictable in a buyout, running hard to stay still, having acquired investments at values that have already factored in the profit improvement over this period. This situation can get even worse if markets correct. This undermines the potential to generate returns over the first two years and pushes any return drivers to the, inherently less reliable, later years.

The high multiples paid reduce significantly the chances of multiple expansion and the effects of deleveraging are also likely to be minimal, given the large

11. This breakdown does not attribute any of the improvement in multiple and debt paydown to the underlying EBITDA growth.

amounts of equity and debt used to finance the acquisitions. The reliance on one, back-end loaded driver of returns may lead to a significantly higher risk of disappointment and investments skewed to the downside.

The second approach of "buying right and creating value early" involves staying focused on entry multiples, rather than IRR models, buying assets at or below their intrinsic value, and finding opportunities where value creation can be engineered through the operation of multiple levers early in the life of an investment. Executed well, this approach creates an early margin of safety, with the focus on moderate entry multiples providing greater protection if asset valuations show a sustained downward move and, conversely, an opportunity for multiple expansion if conditions are benign.

These opportunities can be found more readily by shunning mainstream assets and by forming differentiated and sometimes contrarian views. This differentiated approach to investing is not easy to execute and can sometimes mean taking other forms of risk, albeit ones that are inherently more controllable. It requires three key conditions to be met:

1. The availability of a rich pipeline of differentiated opportunities
2. The ability to make judgements to avoid the pack
3. A toolkit to transform businesses

Differentiated Opportunities

The strategy requires discipline and the resolve to say "no" frequently. It requires a rich pool of opportunities from which to select and sector expertise to generate a quality and differentiated deal flow. This approach also benefits from a global footprint, which can enhance opportunities for value arbitrage, offer potential for global expansion (either organically or through M&A) and optimize exit opportunities.

Avoiding the Pack

Sector expertise is critical, both at the macro level to enable a focus on subsectors which are underappreciated, and at the micro level to find individual companies that have often been overlooked. This requires a skill to look beyond the obvious to find opportunities which are less "picked over," taking differentiated and, sometimes, contrarian views.

A Toolkit to Transform Businesses

Ensuring a business is led by the most effective senior team is priority one. The operational skills of private equity firms should therefore be designed to help strong management teams maximize a business' potential through specific functional expertise; strong management teams don't require general management advice, they require partners that will help them solve critical business issues. Gaining alignment around the transformation program pre-deal is critical to ensure that this program begins on day one.

In essence, identifying good opportunities to buy right and create value early means being able to differentiate between great assets and great investments.

The industry needs to guard against becoming too price-insensitive for supposedly stable assets, making it ever more critical to source differentiated opportunities, execute robust value creation strategies and unlock hidden value—the keys to generating enduring, absolute returns.

MANAGEMENT TEAMS IN A BUYOUT

A strong management team is a key ingredient to a successful buyout. As controlling shareholders, buyout investors have full discretion to choose the teams they work with. A close cooperation between management and the respective partners at the buyout firm is vital to ensure both a smooth acquisition process as well as productive engagement post-acquisition. Depending on how active the role of the management team is during the acquisition process, one can distinguish several types of buyouts, namely, management buyouts (MBOs), management buy-ins (MBIs), and institutional buyouts (IBOs).[12]

MANAGEMENT BUYOUT (MBO): In an MBO, the incumbent management team initiates the buyout of a company or corporate division with the financial backing of a buyout fund. This arrangement allows PE firms to capitalize on the management team's knowledge of the target company and provides a distinct advantage relative to other interested parties. An MBO can be particularly attractive when management, given its familiarity with the business and established relationships with internal and external company stakeholders, wishes to capitalize on new growth opportunities. The acquisition process is often led by the management team with the buyout fund providing, primarily, capital and some of its structuring expertise as a repeat buyer. While successful MBOs provide management teams the opportunity to work in an entrepreneurial environment with greater rewards, failed MBO attempts may lead to alienation between senior management, existing owners and company staff.

MANAGEMENT BUY-IN (MBI): In an MBI, a buyout fund partners with an external management team to pursue an acquisition of a portfolio company. If successful, new management with an equity stake in the firm will replace the incumbent management team. Typical MBI targets have sound growth potential and the right business model but may lack effective management. Buyout firms often work with successful management teams on multiple MBIs, benefiting from an established working relationship. On the downside, MBIs often require a longer due diligence period as the buyout fund cannot leverage the insights of existing management; in addition, possible conflicts between the new management team and existing employees may need to be addressed.

INSTITUTIONAL BUYOUT (IBO): In an IBO, the buyout is initiated by a PE firm without the support of the incumbent or external management team. Rather, a buyout fund negotiates directly with the seller, with little or no support from any management team until the acquisition terms have been agreed. The buyout fund may decide to retain existing management, replace the management team or selectively augment an existing team with new talent for specific roles once the transaction has been finalized. IBOs are by far the most common form of buyouts in mid-sized to large transactions.

12. In addition to the three main types of buyouts discussed in this section, various combinations of the three strategies can be employed. For example, in a 'buy-in management buyout,' the existing management team is bolstered by new team members and partners with the PE sponsor on an acquisition.

TYPES OF BUYOUT TRANSACTIONS

Buyout firms target businesses with diverse forms of current ownership such as privately held, stand-alone businesses, publicly listed companies, divisions of large corporations, and assets sold by government entities. While businesses targeted for an LBO typically generate consistent annual cash flow for debt servicing and have a strong market position, value creation levers available to the buyout fund often vary depending on the target's origin. The following section describes some of the most common strategies employed by buyout funds, the type of businesses targeted and common value creation levers applied.

PUBLIC TO PRIVATE: Publicly listed companies are often acquired in public-to-private (P2P) transactions, also known as take-privates. The principal motivation for taking a company private lies in reduced agency risk—resulting from the often tenuous alignment of interests between public shareholders (the principals) and company management teams (the agent)—under a single owner and the implementation of a governance structure that increases accountability of the management team (Exhibit 4.5). In addition, delisting a business eliminates the costs associated with public reporting and the focus on short-term, quarterly earnings in a publicly listed business, freeing management to focus on long-term value creation. Taking a business private also allows a company to carry more leverage. A PE firm's conviction in the value creation potential is reflected in the (at times large) premiums paid by PE funds to delist businesses.

Exhibit 4.5 PE Value-add: P2P

CARVE-OUT: Buyout funds often acquire a corporate division, business unit or subsidiary and set it up as a stand-alone company. It makes for a viable strategy for business units that, for example, are no longer core to a company's strategy or that were unsuccessfully integrated during a corporate merger or acquisition (Exhibit 4.6). These divisions often do not receive adequate attention from top management, appropriate funding or talent relative to other more dynamic business units, and may be structured in a suboptimal way due to a bloated cost structure or inexact allocation of overhead expense. In carve-outs, PE firms principally unlock value by developing a robust strategy for the new, stand-alone company, establishing governance and control systems and providing adequate funding to expand business operations.

Exhibit 4.6 PE Value-add: Carve-out

PRIVATIZATION: Government privatization programs provide a rich source of targets for buyout funds. Significant value can be unlocked in state-owned institutions by updating the company's business model, reducing cost inefficiencies systemic in the public sector, providing fresh resources for growth and focusing management on profit maximization; non-financial goals traditionally pursued by state-owned businesses may be sacrificed in the process (Exhibit 4.7). PE firms can also add value by replacing dated decision-making processes with an updated governance structure that empowers employees throughout the organization.

Exhibit 4.7 PE Value-add: Privatization

FAMILY BUSINESS: Privately owned family businesses[13] are a popular target for buyout funds, as external management teams installed by a fund can rapidly professionalize a business and drive value creation (Exhibit 4.8). As decision-making in family businesses often rests with a single founder or a core group of family members, updated corporate governance measures, including the establishment of a formal advisory board with

13. Family businesses often use buyouts as a viable succession option.

independent directors, can help remove biases related to personal relationships and introduce checks and balances at appropriate levels of the business. PE firms can create value by leveraging strong brands and relationships built under family ownership, or by updating legacy strategies and focusing on cost reduction. It is important to note that positive attributes of a family business, such as close networks, a strong company culture or the loyalty of employees to the family, are sometimes diluted under the new ownership.

Exhibit 4.8 PE Value-add: Family Business

SECONDARY BUYOUT: Portfolio companies controlled by another buyout fund are frequent acquisition targets and such transactions are referred to as secondary buyouts. The principal opportunity to add value here is through strategic realignment (Exhibit 4.9). Although the exiting PE firm has likely capitalized on a range of value creation opportunities, the acquiring PE firm may bring a unique combination of skills, knowledge and in-house networks to drive new strategic initiatives at the company. In the case of a prior LBO, these targets have "proven" their ability to service debt, and current management has experience running a levered business; therefore, a larger proportion of debt financing can often be secured for a secondary buyout.

Exhibit 4.9 PE Value-add: Secondary Buyout

CLOSING

Mention PE and audiences will often think of buyouts first. Indeed, buyouts make up the largest (in dollar terms) and often most visible part of all PE transactions and constitute a sizable portion of all mergers and acquisitions. Defined in the early years by their aggressive use of debt, buyout funds have long become smart operators, increasingly driving value creation in their portfolio companies with the help of operating partners. The governance mechanisms that are central to their business model include full equity control and interest alignment with management and will be the focus of distinct chapters later in the book.

KEY LEARNING POINTS

- **In a buyout, PE investors acquire a controlling equity stake in a target allowing them to make all financial, strategic and operational business decisions.**

- **Management teams execute the investment strategy of the fund, making it paramount to create an incentive scheme that aligns the interests of management and PE owners.**

- **Most buyouts are structured as LBOs with debt financing a large portion of the acquisition price.**

RELEVANT CASE STUDIES

from *Private Equity in Action—Case Studies from Developed and Emerging Markets*

Case #11: Chips on the Side (A): The Buyout of Avago Technologies

Case #13: Going Places: The Buyout of Amadeus Global Travel Distribution

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ALTERNATIVE STRATEGIES 5

Funds that invest in venture capital, growth equity and buyout deals constitute the backbone of the private equity (PE) industry. Yet, as the industry matured and assets under management grew, PE firms started to look further afield – to different markets, assets and previously untapped business situations – to deploy capital and apply their skills.

Our introductory section on PE would not be complete without a closer look at two of these alternative strategies: distressed PE and real asset investing. The evolution and appeal of these strategies has much to do with their different risk–return profiles and the demand from limited partners (LPs) for returns that historically have been uncorrelated with their traditional portfolios. Both areas are composed of several substrategies: distressed PE investing includes corporate turnaround and distressed debt strategies, while real asset investing includes real estate, infrastructure and natural resources.

DISTRESSED PRIVATE EQUITY

Distressed PE funds invest in mature companies in need of substantial restructuring in the face of imminent failure or bankruptcy. While the reasons for distress may be complex, the PE investor will frequently find a business straining under an unsustainable debt burden or struggling to make an inefficient operating model work, or quite often a combination of both. Addressing these issues requires highly specialized teams experienced in turnaround management and financial restructuring under extreme time constraints. Given the poor state of a typical target company, distressed PE investors must act decisively after limited due diligence, gain control of the company and immediately attend to short-term liquidity issues to ensure the firm survives and can be repositioned for recovery: no survival without recovery; no recovery without survival. While the specific circumstances and degree of distress vary from deal to deal, PE funds in this space subscribe to a common approach: gain control of the asset at a discounted valuation and drive the restructuring process quickly and efficiently.

In the section that follows, we take a closer look at the two main distressed PE strategies: turnaround investing and distressed debt investing, and touch in turn on some of the causes of distress.

TURNAROUND INVESTING

Turnaround funds acquire majority equity stakes in mature companies that are in considerable operational distress.

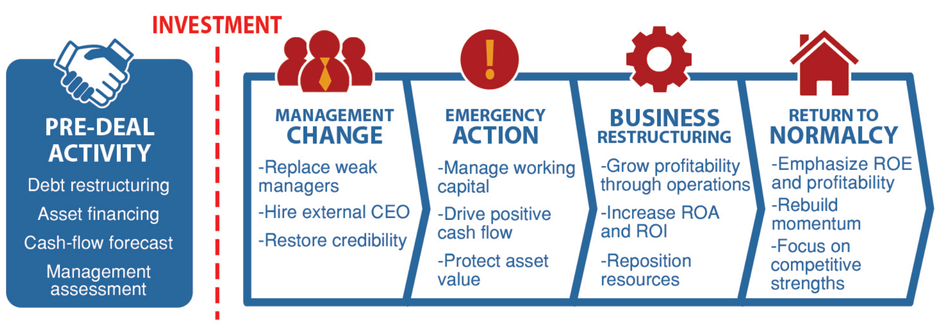
Majority equity stakes are a prerequisite for most turnaround investors. In a situation that requires quick and decisive actions based on a rigorous diagnostic review of the business immediately post-investment and an analysis of the various stakeholder positions, a controlling stake is indispensable.[1] The PE team will need ready access to all aspects of the business, since the often rapidly dwindling cash of the firm may impede even the day-to-day operations of the portfolio firm. Negotiations with banks, creditors and suppliers will commence without delay to ensure their cooperation.

Target companies are typically generating significant operating losses and burning through cash reserves at the time of investment. The modus operandi for a turnaround fund is an immediate maximization of short-term cash flow to stabilize the business and avoid insolvency. To get clarity on the urgency of the situation and the time available to implement improvements, a detailed short-term cash flow analysis—a 13-week cash flow forecast is industry best practice—needs to be performed. "Cash is king" in the world of turnaround investing: finding it, unlocking it, and driving cash flow improvement to remain solvent and operational are crucial.

Turnaround investing requires an investment team that can reliably assess the feasibility of a turnaround opportunity during due diligence, complemented by an operating team adept at rapidly addressing weaknesses in the operating business and affecting change. This task may be complicated by the need to manage not only a financial restructuring program and negotiations with stakeholders, but also the legal challenge of avoiding bankruptcy. Given the lack of a global bankruptcy code, the latter requires having local, country-by-country legal expertise in-house. As maintaining a full team of turnaround professionals entails significant cost, this strategy is clearly a niche undertaking for truly experienced funds and presents a high barrier to entry into this segment of the PE industry.

No turnaround situation is alike, but Exhibit 5.1 shows the typical steps recommended by turnaround experts.

Exhibit 5.1 Typical Turnaround Process



Source: Turnaround Management Association

When dealing with target firms in dire straits, protecting the PE fund's interest (and in turn that of its LPs) is paramount, and turnaround funds will ensure that certain

1. Turnaround funds are not always able to acquire a controlling position from the outset, as some equity owners may only be willing to relinquish their stakes in the firm over time. This adds the risk of a prolonged holding period, which may in turn lower internal rates of return.