

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

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February 2020

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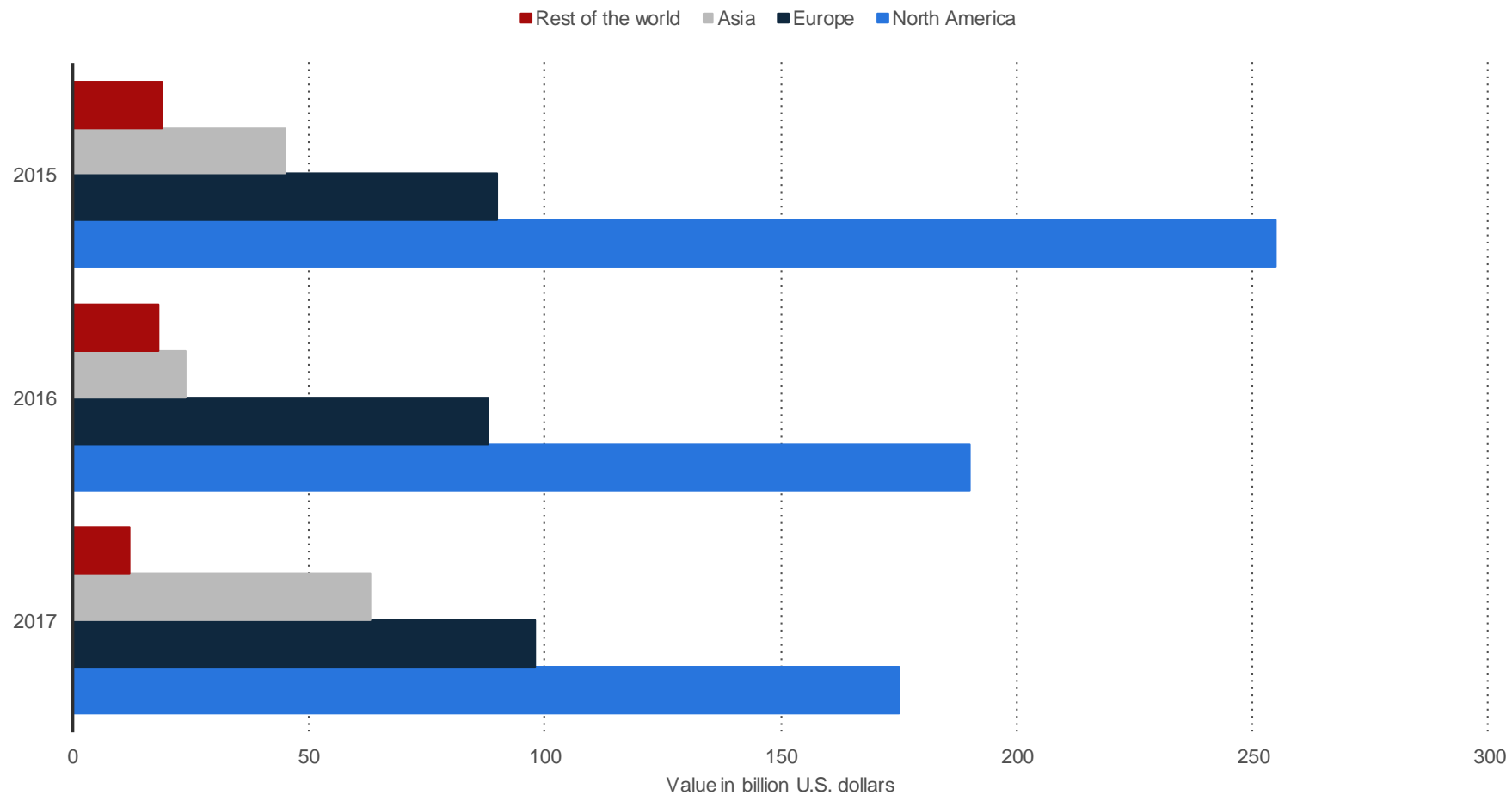
# Private equity : What is it?

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

Key elements of private equity are:

- Investment in unquoted companies
- Equity capital by nature
- Medium to long term
- Targeted at companies with growth potential

# Geography of Private Equity : Where is the capital being invested



**Private equity: How important is it economically?**

Many house hold names have been previously backed by private equity...

*Not exhaustive*



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

*Not exhaustive*



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

## Private equity : How important is private equity economically?

- According to IE Consulting in 2007 companies in the UK that have received private equity backing accounted for the employment of c3 million people in the UK, amounting to 21% of the UK private sector workforce.
- IE Consulting also said that in 2007 private equity backed companies in the UK generated total sales of £310 billion and contributed more than £35 billion in taxes.
- The portfolio companies taken together of each of Carlyle, KKR, Blackstone and Apollo rank among the 10 largest employers in the US.
- According to Bain in 2013 private equity backed companies accounted for 23% of the US's mid-sized companies and 11% of its large companies.
- What are the consequences of all this for labour productivity, compensation per worker and employment?

## Private equity : How important is it to M&A?

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

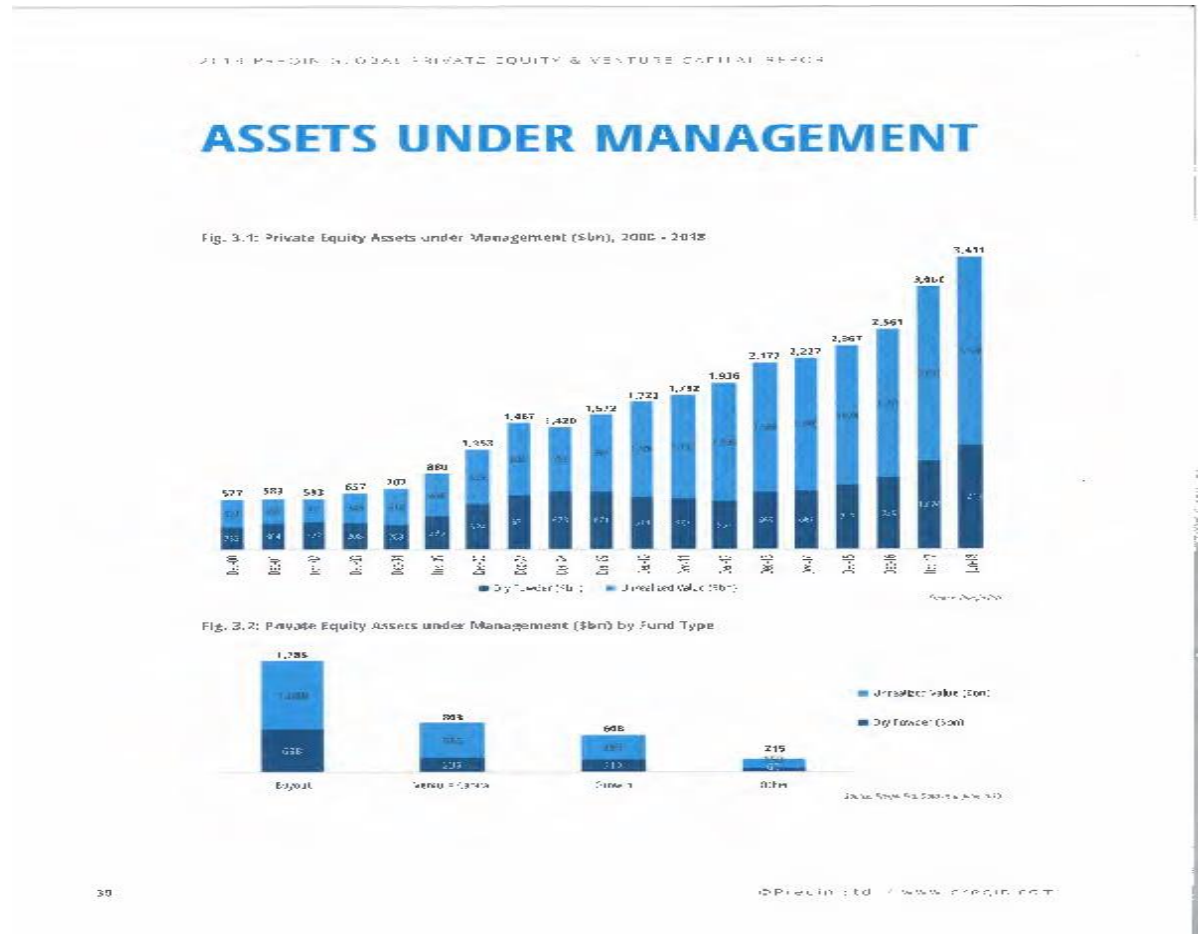
Source: Wachtell Lipton

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

Source: CMBOR

# How has private equity grown?

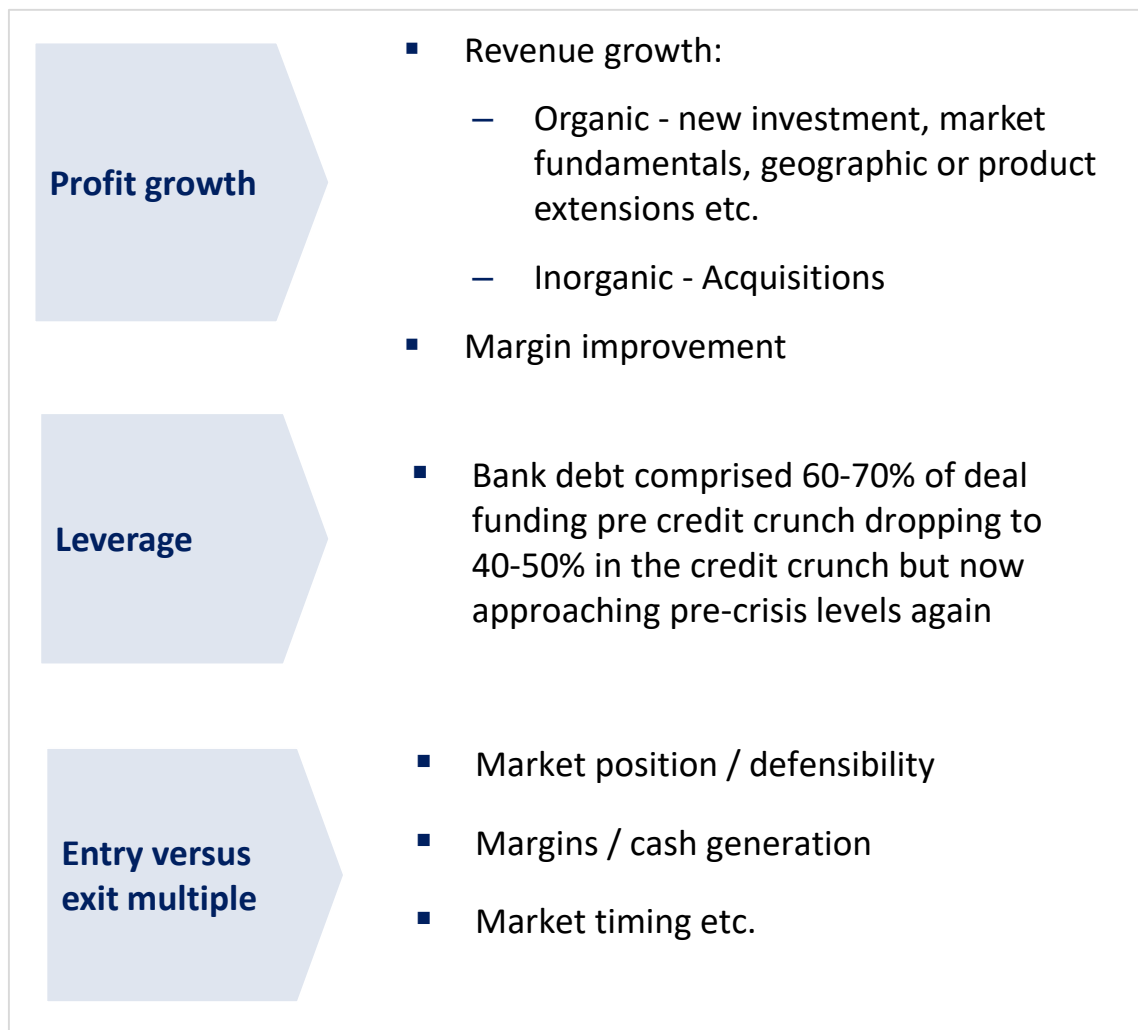
See hand out





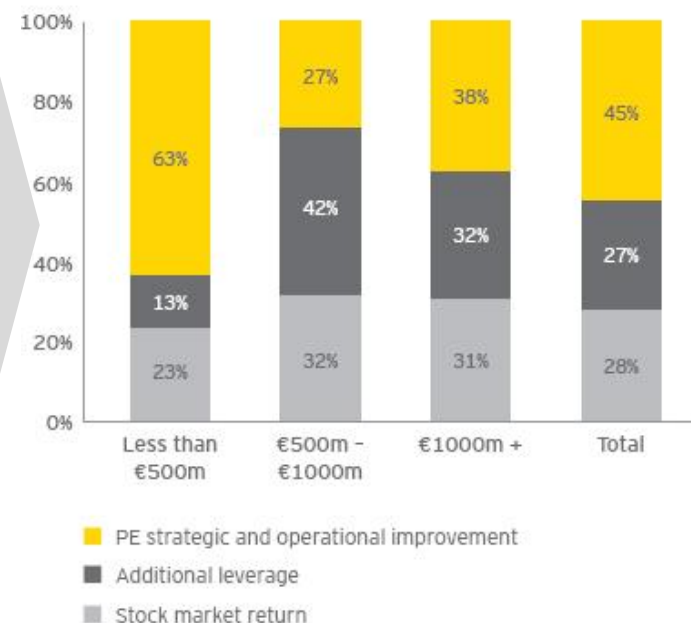
## Why has private equity been successful?

There are 3 main ways in which private equity creates value



### Returns from PE relative to the stock markets\*

Entry EV range, 2005 - 2011



\* Source: EY

# Private Equity vs Public Companies

- Universe of listed companies in UK and US shrinking dramatically.
- Why?
- But size of remaining listed companies increasing.
- Will this trend continue?

# How does private equity work? At the house or fund level

# What is a private equity house?

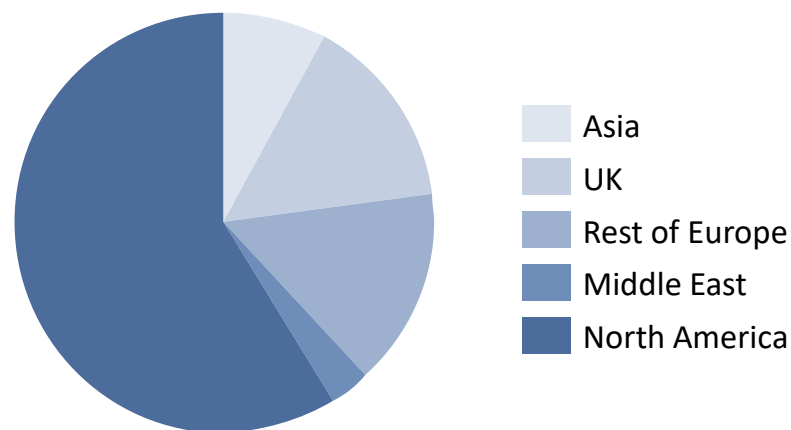
- Most are independent raising funds from outside investors and whose money they manage, the fund typically being structured as a limited partnership
- Some are listed companies, such as 3i, investing balance sheet money
- Funds will have a limited life, as we will explain, will be illiquid and will not have borrowings

## Who invests in Private Equity?

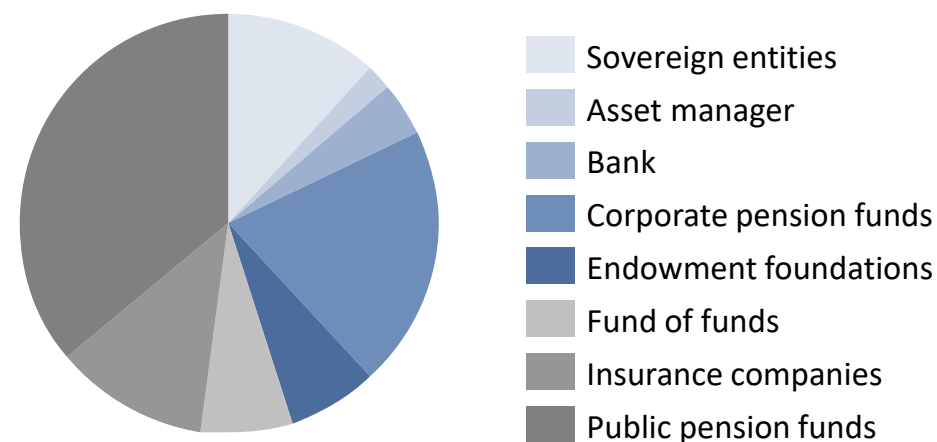
### Main investors in Private Equity include pension funds and insurance companies

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

#### Investors by geography in Bridgepoint funds



#### Investors by type in Bridgepoint funds



\*London Business School Coller Institute of Private Equity

# INVESTORS

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

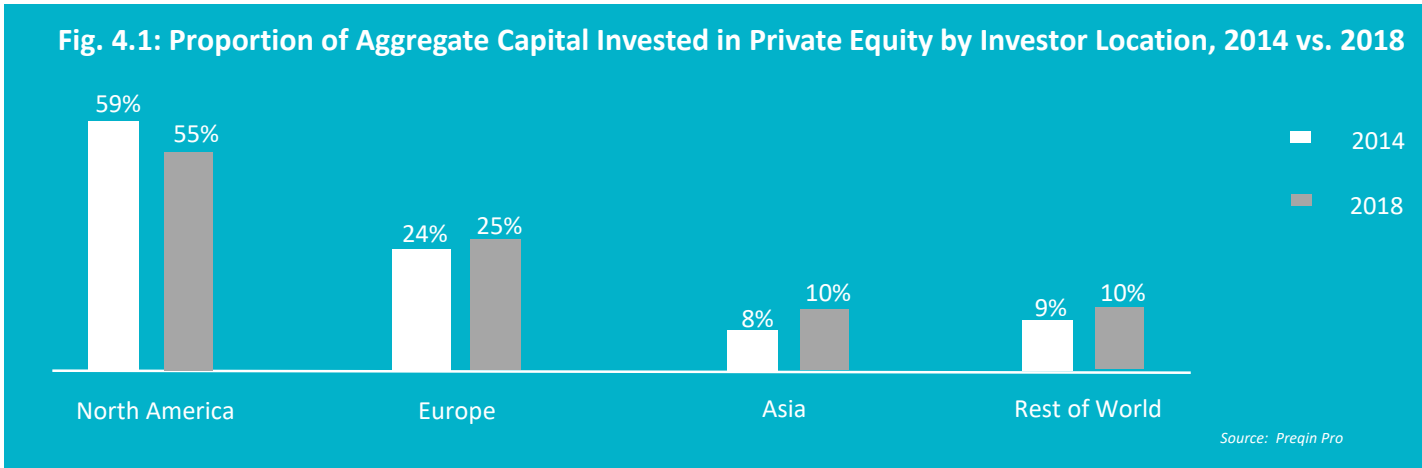
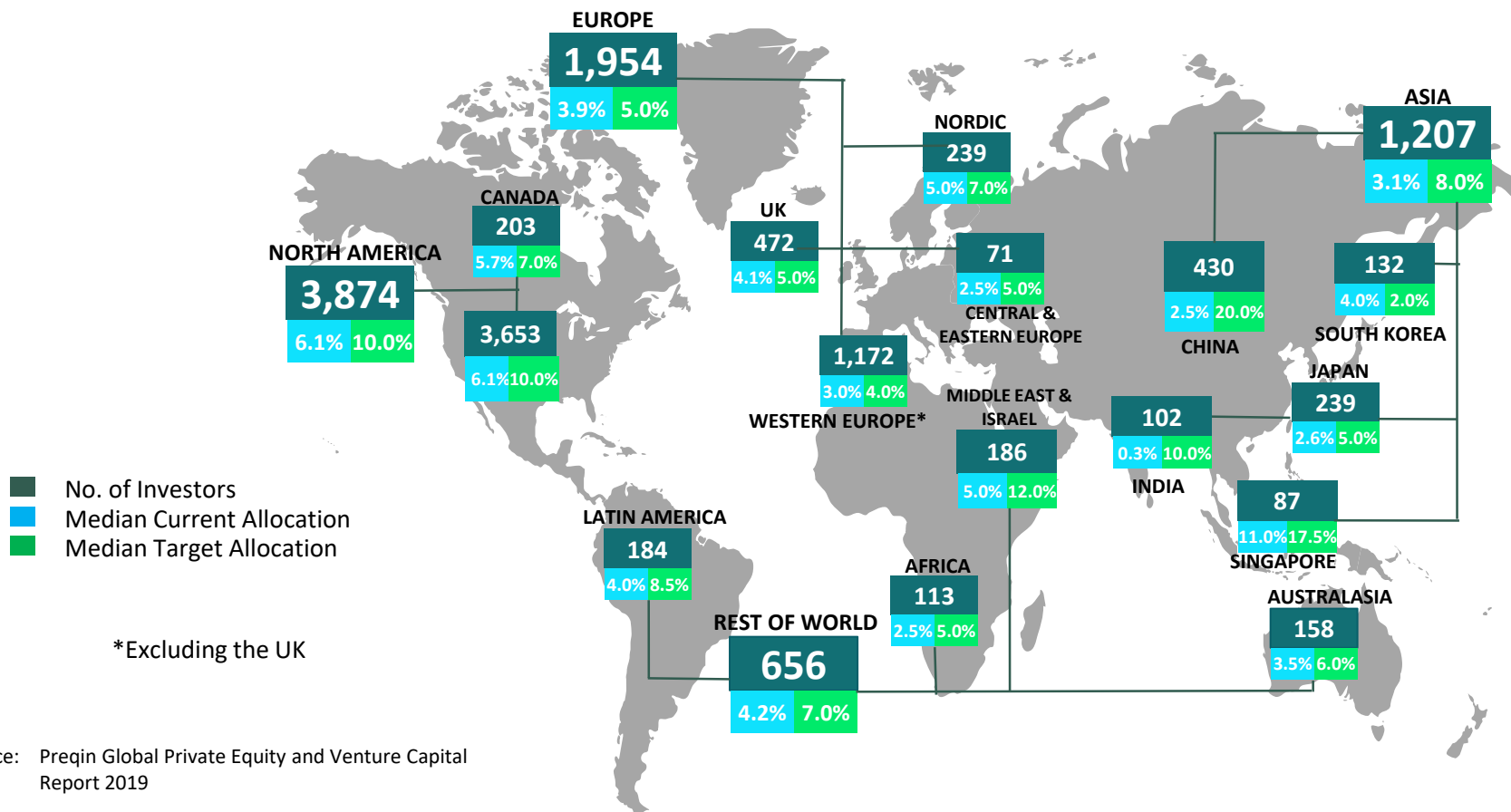


Fig 4.2: Institutional Investors in Private Equity: Number and Median Current and Target Allocations (As a % of Total AUM) to Private Equity)



## How does a limited life fund work? Lifecycles of Private Equity Funds typically last 10 years

Detailed further

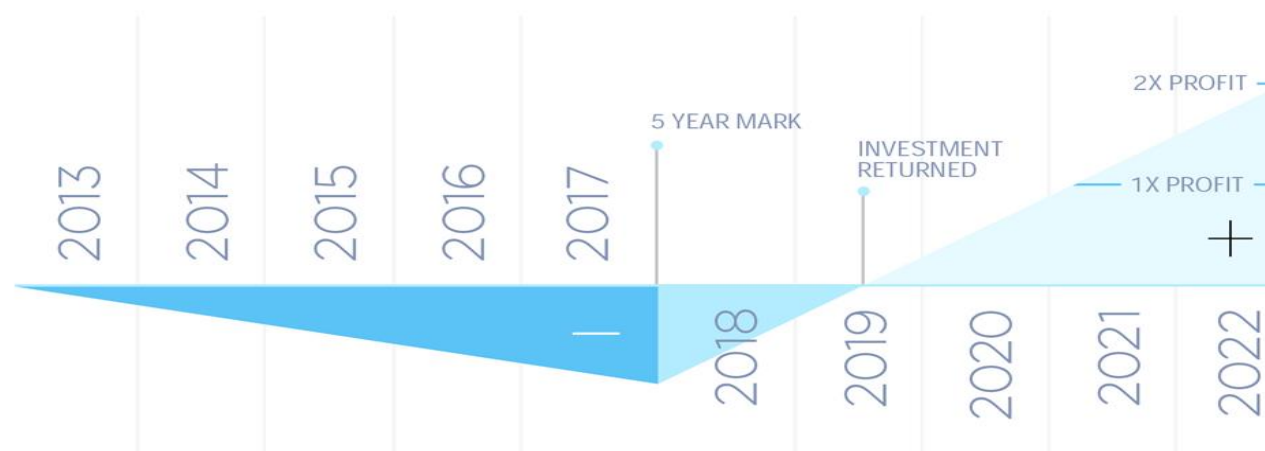


**LIFE CYCLE OF A  
PRIVATE EQUITY FUND**

Investment  
Investment returned  
Profit

*Illustrative*

**RETURNS YEARS**  
2018-2022  
funds are returned/profits are generated



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

## What returns does private equity target?

- In buy-outs, a c. 20-25% IRR and a cash-on-cash money multiple of 2-3x +
- In venture capital and some buy-outs which are seen as riskier, the target returns will be higher
- Funds have different target returns and different variances in their returns
- Average hold period 4 years for buy-outs – but these increased dramatically during the economic downturn

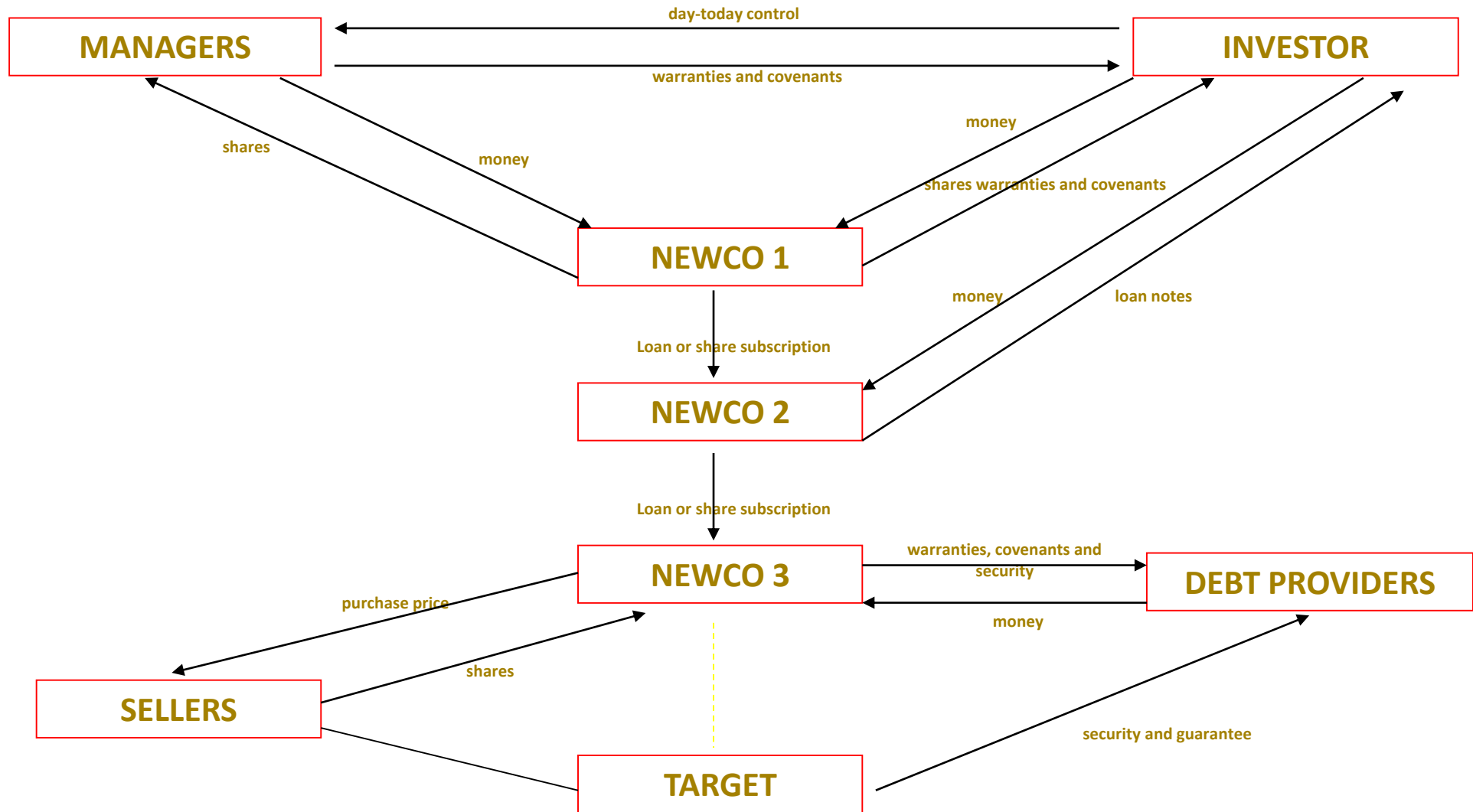


## How are private equity fund managers remunerated?

- Management fees – usually 1.5% to 2% per annum
- Carry, i.e. participation in performance of fund above a certain level
- Co-invest, i.e. executives of private equity houses can invest in-house deals
- Current trends – the importance of co-investment, deal by deal structures

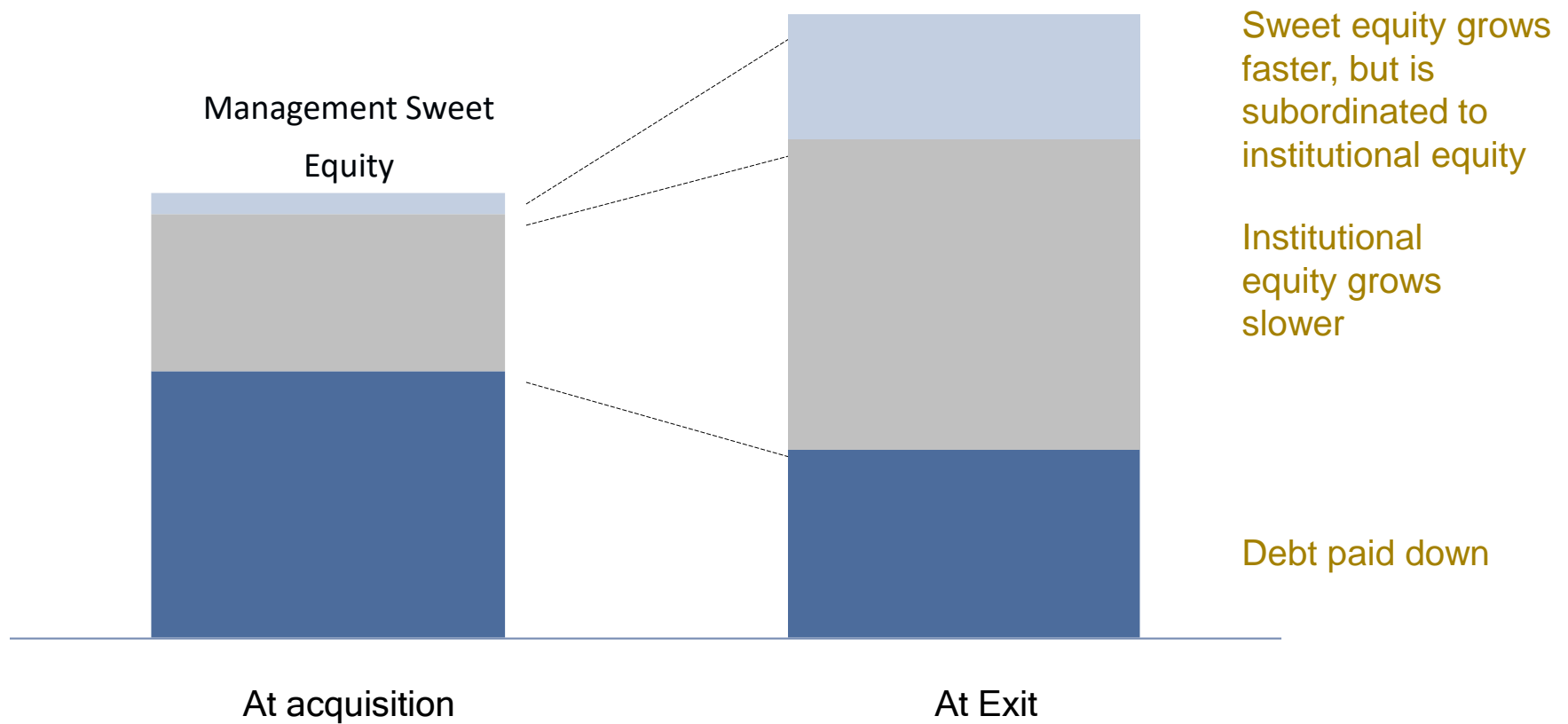
# How does private equity work? At the deal level

# How Private Equity Works: A Typical Buyout Structure



# How returns are split

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



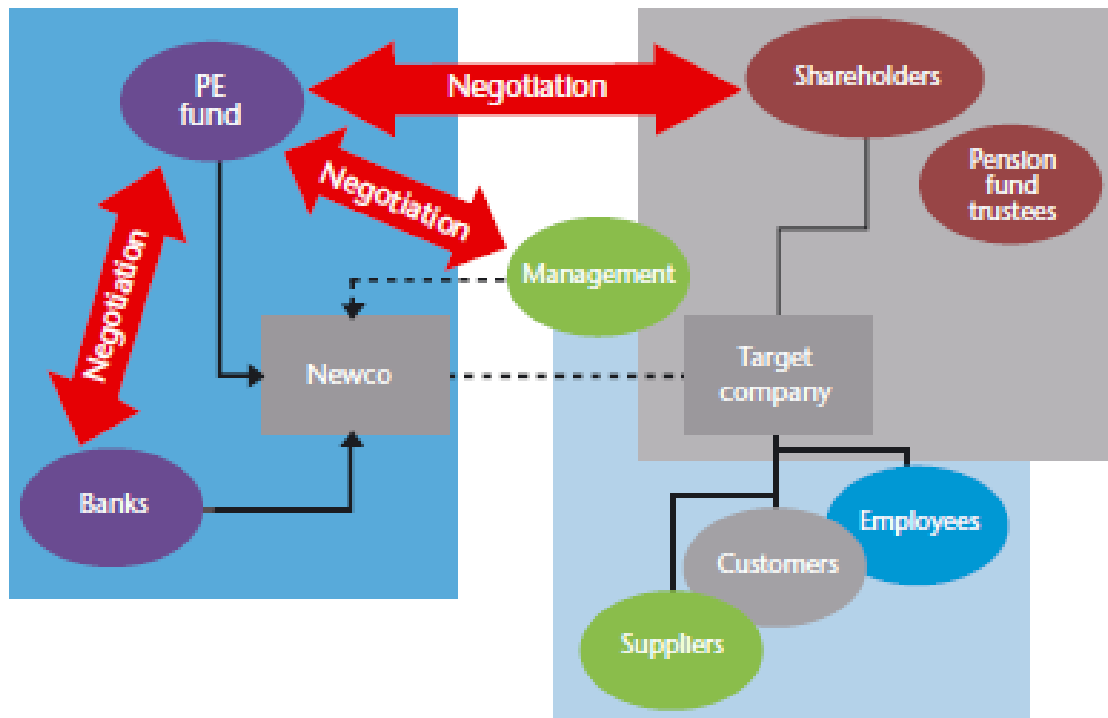
Note: Values are illustrative only.

# Private Equity and its affect on M&A

- Changed the dynamics. The sell side came to dominate.
- Professionalisation and development of sophisticated due diligence.
- Management became significant players in the process.

## There are many participants involved in Leveraged Buy-Outs

### Participants in a leveraged buy-out



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

- Corporate finance advisers for buyer and seller
- Legal counsel for buyer, management, seller and banks
- Accountants for buyer and seller
- Tax experts
- Insurance experts
- Environmental experts
- Pension experts
- Property experts
- PR/communications for buyer and seller
- Etc.

**Legal advisors play a key role in the deal structuring and execution phase**

**Key Documentation : Acquisition**

- Sale and purchase agreement
- Sets out price – locked box vs completion accounts
- Warranties – what they are there to do
- UK vs US practice

## Legal advisors play a key role in the deal structuring and execution phase

### Key Documentation : Equity

- Shareholders' or Investment Agreement
  - Subscription
  - Warranties and restrictive covenants
  - Governance architecture
  - Exit provisions
  
- Articles of Association
  - Classes of capital (voting, income, redemption, conversion, rights on liquidation)
  - Share transfers
  - Leaver provisions
  - Tag and drag rights



## Legal advisors play a key role in the deal structuring and execution phase

### Key Debt Documentation : Debt

- Senior Debt evidenced by Facilities Agreement
  - mechanics for drawdown, repayment and payment of interest warranties
  - covenants – restrictive, positive and financial
  - events of default – e.g. on non-payment, loan accelerates/on demand
  - secured
  
- Mezzanine
  - follows senior
  - higher interest rate, higher fees
  - equity option (warrants) sometimes
  
- Unitranche
- DCM

# Current Trends and Final Thoughts

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