Business Sales | Acquisitions | Corporate Finance | Strategy

Guide 5
Financing

AVONDALE

AVONDALE

Guide 5
Financing

Avondale is a leading Mergers & Acquisitions strategy consultancy. We have been working with the best entrepreneurs and companies for almost 30 years. Operating both locally and globally, the firm has offices in the UK and Central Europe.

We provide a fully integrated service from business sales and acquisitions to business growth, strategy and employee ownership. Solutions-led, we combine our expertise with ambition, resource and vision – partners that drive value and deliver your goals.

Businesses always require cash, particularly if they are growing, therefore the financing journey is continuous. In this Guide we consider the art of financing a deal. Where best to secure the funds, what type of financing plan is best for a particular venture? How can we service the debt? Would we be better off with equity finance or debt, or a mix of both?

This series of Guides, authored by Avondale Principle Consultants, is intended for the benefit and information of senior affiliates and top-level entrepreneurs.

Other Guides in the series:
Guide 1: Valuation Methods and Multiple Arbitrage
Guide 2: Employee Ownership Trusts
Guide 3: Exit Strategies by Design
Guide 4: Acquisitions
with more to follow in 2020.

These can all be accessed on our website: www/https://avondale.co.uk/guides

Please contact av@avondale.co.uk if you have any questions

INTRODUCTION

If carried out correctly, acquisitions may be the best route to achieving competitive advantage and return on capital employed. However, as with so many elements of mergers and acquisitions, there is an art to financing the deal, including questions like 'where do we best raise the money and which type and structure of debt is best?' Funding is also important to securing shareholder value. How much should we re-invest for organic growth to secure a return on capital? What debt should we have to secure that growth? This guide is aimed at answering these questions.

One further important question: if cash reserves are available should they be used to generate return and if so, how much, or should the deal or investment be highly leveraged? Debt is cheap when you consider the opportunity value of retaining money. In translation, a company might have enough funds to carry out one acquisition from cash but if the right opportunities are available, should the company buy two? It would almost invariably make sense to do two deals and debt fund half of each or more, as interest rates are generally much lower than the return on investment from the right purchase. The profits in the acquired company should help service the debt. This is known as a 'leveraged' acquisition. That is, using borrowed capital for an investment and expecting the profits made to be greater than the interest payable. The equation does, however, become more complex when you consider acquisition versus organic growth investment.

Achieving your commercial ambitions, whether looking to achieve shareholder value or carrying out an acquisition, requires up to date knowledge on funding options so this guide looks at the concepts, rather than the specifics, of which current lending or equity options have the best approach.

Each approach should be tailored to the optimal solution for your needs; appropriate, attainable and with the risk carefully considered. Banks may recall loans which are not serviced, your home may be at risk and your business certainly will be.

Finally, to secure debt financing and/or investment, you need to make sure your business proposition or acquisition is clear and understandable to your target audience – with a business plan. Advice should be taken from professionals, particularly on how best to present the financials against the risk, the rate of return, the cost of debt or equity and finally analysing the business stage. These are all aspects which we will cover in this guide.

THE BUSINESS STAGE

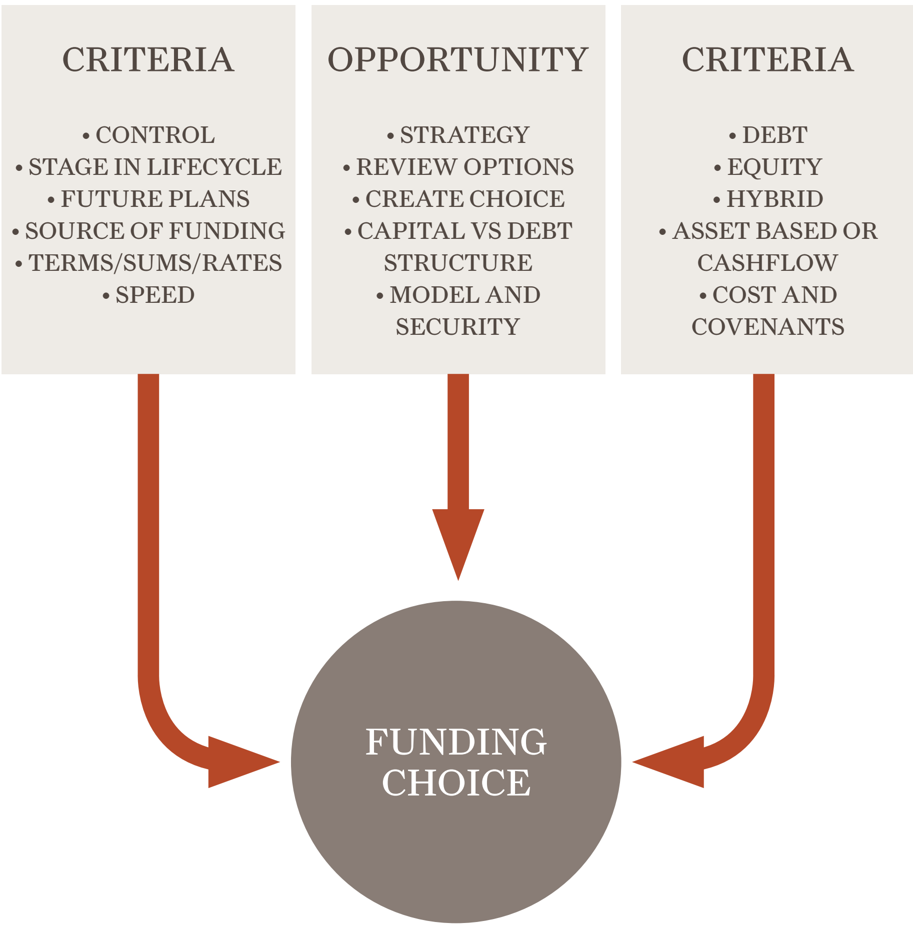
Businesses always require cash, particularly if they are growing, therefore the financing journey is continuous, with different approaches ranging from self-financing to third party debt or equity at different stages of a business's overall lifecycle. Being able to access the right type of finance at the right time is vital for business growth. At the start there may be overdrafts, or perhaps personal loans from friends and family. Later there may be institutional investors backing the venture to public companies. Management will need to ensure that future growth can be financed. For many leaders and entrepreneurs this is a challenge, as invariably their focus is on products, customers and services and they often see finance as less exciting administration or the realm only of the accountants.

Value can be gained and achieved by actively exploring both finance and cash management options, and understanding them, to suit the right time and stage in a business.

Analysis of a carefully prepared forecast profit and loss account and balance sheet and then crucially the cash flow, allowing for seasonality, can clearly highlight how much capital the business needs for the current business plans and stage. In turn this analysis gives certainty and can create confidence and clarity to the leadership team along with a vision for the business. Rather than an administration job, exploring cash flow and financing options can, in fact, crucially invigorate a business strategy as the right funding options can drive growth.

The analysis is not just part of the preparation for taking on new investment or debt; it is a procedure that must be ongoing, particularly if new stakeholders or equity providers are to be sought who will want to carry out ongoing reviews. Lenders and stakeholders also need to be managed and a relationship built around reporting on the numbers.

THE FUNDING CHOICE



CREATING A BUSINESS PLANNING AND FUNDING INFORMATION PACK

When we review our plans, an acquisition or our business cycle, we need to reinforce our thinking, and any potential lenders or equity providers' understanding, with both information and a solid business plan. The plan helps lenders or investors to understand the vision and goals to secure funding whilst also creating clarity for the business leaders.

Business can be complex so plans should be short and simple. Many leaders fail to secure funding with unfocused jargon-filled propositions that fail to address the risks in a strategy and the impact of any deviations. Plans and information will depend on the target audience but should incorporate:

- An executive summary which grabs attention;
- Market analysis of the company, its products, services and competitors;
- Key accounting ratios and cash flow data;
- An analysis of the client base, particularly any demonstrable recurring elements;
- Details of key personnel, their responsibilities, skills and experience;
- A marketing plan targeting new or existing customers;
- Historic financial information; details of the last 3 plus years of trading;
- Covering of downside risk;
- Forecasts for the next 2-3 years, ideally in the same presentation style as historic financials;
- Cash flow forecasts covering a 3-year period, highlighting the amount of funding required and how creditors, capital expenditure, debtors and stock will be managed;
- Details of any tax relief available from investment in the venture.

Once the business plan work has been carried out, it is best summarised in an investment or lender memorandum to encapsulate the key points. Realistic yet punchy, this presentation will also include details of the commitments the existing shareholders are prepared to make known rather colloquially as 'skin in the game'. Such 'skin' reduces risk by motivating those vital extra hours and the commitment that may be required to break through when trade becomes tough, which invariably it will, at some stage.

When analysing the business plan, a headroom analysis can also show how debt can be serviced at various interest levels: interest only or interest and capital repayment against various periods. A repayment schedule linked to the forecasts will make this clear.

Where equity investment is being sought, the plan or memorandum will also need to show the potential stake for investors; how they would receive dividends. It will also need to include various models demonstrating the value of the business and how their investment will grow in shareholder or 'capital' value. The business plan is definitive, and the data should be backed by analysis throughout, enabling different equity investors and debt providers to match their requirements.

CASH MANAGEMENT

Over time, profitable companies may build up significant reserves, particularly as paying dividends is not always appropriate. Such a 'war-chest' helps to manage risk, however, it will generate a low yield on capital and therefore, rather than being held as cash, it can be used for dividends, acquisitions or a company buy-back of shares to the long-term benefit of shareholders. Cash management is critical to securing debt or equity, including analysis of:

- Stockholding levels and steps being taken to actively reduce excess;
- Invoicing and credit management procedures;
- Payment terms and working capital;
- Stock and work-in-progress (WIP) levels;
- Contractual agreements with suppliers and credit terms;
- Capital expenditure (CAPEX) age and the lifecycle of equipment;
- CAPEX outright purchase versus leasing;
- Headroom and risk on debt serviceability.

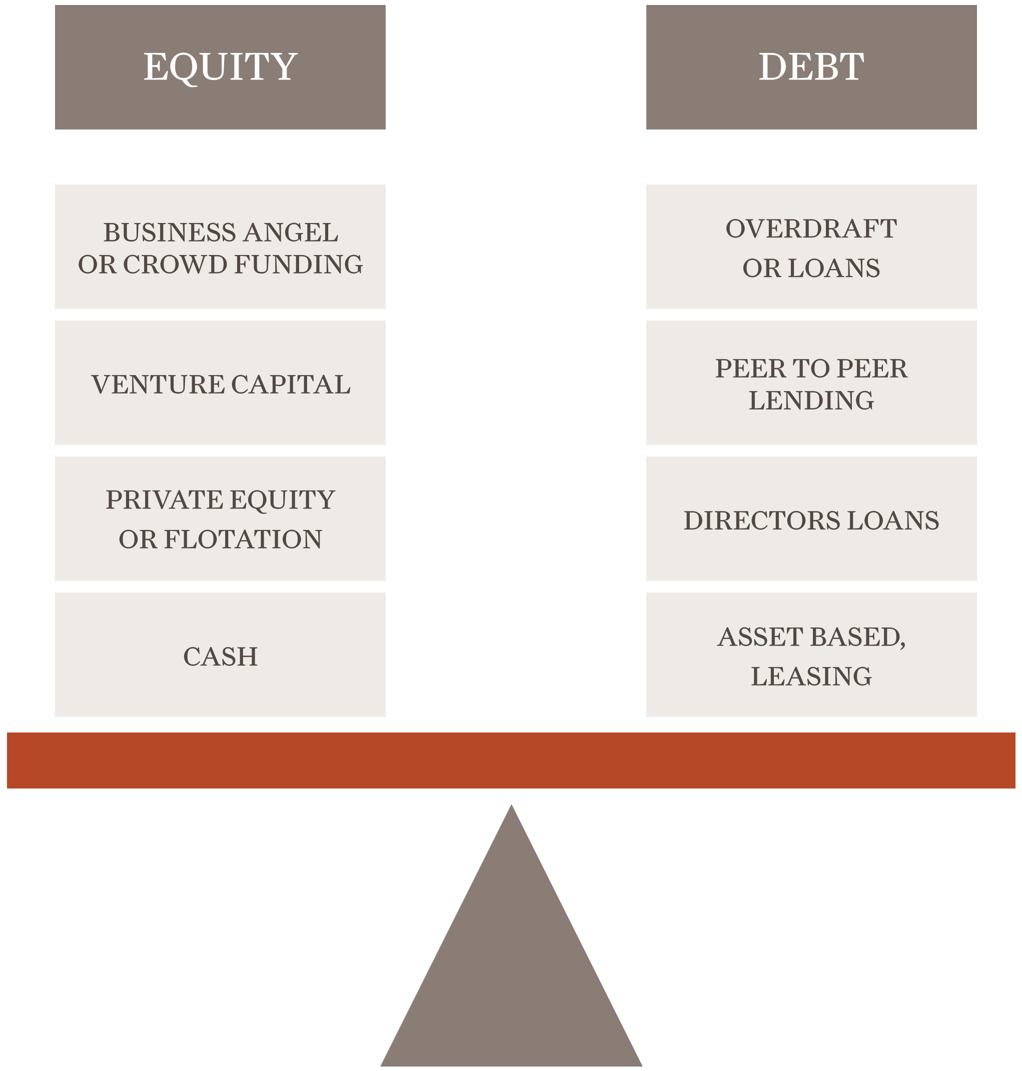
Understanding the real cash position is not just part of the preparation for taking on new investment or debt, it is a procedure that must be ongoing. Full monthly analysis of both the balance sheet and the profit and loss account are essential to effective lending. This means that systems and the capability for real-time financial reporting are important to companies seeking borrowing. Analysing the cash cycle and working capital in a business is an essential part of acquisitions.

FUNDING OPTIONS

Once we have better understood our business plan, cash position and cash flow, we can create an information pack to use when approaching lenders for finance. The modern approach is to do this with a data room with full access to the financial models, cashflow forecasts, historic numbers and management information. With a carefully created information pack, it is time to explore the lending options for our venture or acquisition.

Expert advice is needed to assess how financing options may suit each venture. Larger sums for ambitious plans will require equity funding, whereas debt lending should cover most other eventualities. There is a myriad of options with many new types of lending facilities now available, from sources such as crowd funding to challenger banks. Invariably a blend of products may be the best way for a business to take on debt and equity finance. Short-term capital should not be used to fund long-term plans, so the reverse is true. The finance options include:

DEBT VS. EQUITY BALANCE



EQUITY FINANCE OR DEBT?

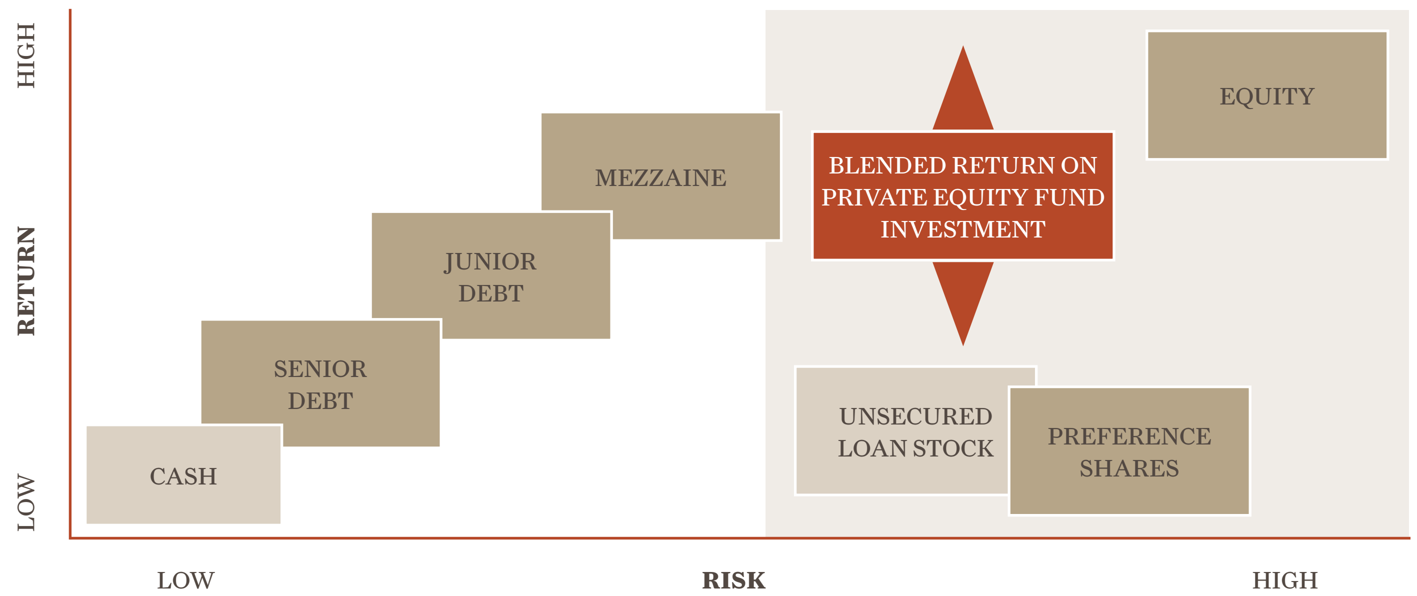
Usually debt is cheaper than equity, however, it may be riskier as banks or lenders may lend against cashflow or assets on a fixed schedule or ongoing basis. If, however, there is a default on this fixed schedule they can and will foreclose. Equity investment - the raising of capital through the sale of shares - is more 'patient' money which has been invested in exchange for shares, usually against a later exit. However, buying back shares may prove costly, particularly if the venture is successful.

When I was starting out in adult life my father, an accountant, helped me to buy my first house. I didn't have much of a deposit, so he lent me £10,000, in exchange for which I offered him 20% of the equity. Two and a half years later I sold the house and the same 20% was worth £16,000, didn't he do well?! The cost was far greater than the interest, but I couldn't have borrowed the money as my income was insufficient. I can't remember but I may have paid him interest as well!

Such equity investment, however flexible, works well when starting out or experiencing a high-growth phase. It is also lower risk as it can't be recalled in the same way as debt can. Equity investment can range from taking minority to majority stakes and would usually bring expertise with the investment. In the early stages, businesses will need a long-term backer who can fund the business through to revenue and profit – this could be through 'business angels' and/or venture capital. In the shorter term, equity growth investment can support an aggressive growth strategy.

Debt comes in many different forms and may be used as a blend, for example, there may be long-term leasing against fixed assets whilst an overdraft helps to cope with seasonality in a business. In debt a capital sum is borrowed from a lender who will charge interest for their profit. The capital will be due back either later, or over a period, on a repayment schedule. Debt will usually be charged against the business in the case of default. Lenders may foreclose on a company, and any guarantees which may have been given, in order to recover what they can of their capital. The higher the sum, the more likely lenders are to seek personal guarantees and invariably security will be sought. If things go wrong, insolvency can beckon. In some countries this can be seen, regrettably, as a sign of instability, leading to future issues with borrowing for the founders or shareholders. In other regions, particularly the USA, failure can be part of the process required to get the model, and venture, right.

TYPES OF FINANCIAL INSTRUMENT: RISK AND REWARD



DEBT

Debt can be raised in multiple ways which will depend upon the:

- Risk the lender is taking and regulatory requirements for responsible underwriting;
- Credit history of the borrower;
- Purpose of the loan, amount and period required;
- Affordability and cashflow headroom of the borrower;
- Interest cost of the money on loan;
- Security or collateral the lender can claim against in the case of a loan default.

Loans will suit long-term commitments whereas overdrafts tend to be better for more short-term instances, usually as the business grows. To obtain a loan or overdraft, management must prove to the lender that the business will generate the income and cash to both service and repay the interest payments. Professional advice can help analyse the best method.

Security will often be a debenture against the business and its creditworthiness, rather than any specific asset but it can also be personal, such as shareholders' property. This significantly reduces the lender's risk but does increase the borrower's risk. In the UK, the Enterprise Finance Guarantee (EFG) programme provides loan guarantees, encouraging lending institutions, including banks, to lend to viable smaller businesses that would otherwise be declined for lack of adequate security. At the time of writing, the EFG cannot be used for acquisition finance.

A bullet loan can also feature. This is the business equivalent of an interest only mortgage with a full capital holiday that repays the capital in a single repayment at the end of the loan. Because the capital is not repaid until the end of the loan period, cash is preserved in the business over the life of the loan as long as either the cash retained in the business generates sufficient cash to repay the bullet repayment, or the business is able to refinance the bullet at maturity. The use of a bullet loan increases gearing and therefore equity returns.

Using debt rather than equity to fund a business may reduce the corporation tax bill of any company because some interest is deducted from profits before tax is calculated, whereas dividends are not. Types of loan include:

Leasing: Leasing or hire purchase agreements are suited to larger longer-term purchases, such as investment in plant and machinery, computers or transport. Loans are secured largely on the asset being financed so the need for additional collateral is much reduced and there is more security for the user because the loan cannot be recalled during the life of the agreement.

A finance lease transfers all the rights and obligations of ownership to the lessee and can be for any length of time but, at the end of the lease, the lessee will have paid at least 90% of the fair value, or market value, of the asset through an agreed schedule of repayments. An operating lease, or contract hire, is appropriate if the business will not need the equipment for its entire working life. The leasing company will take it back at the end of the lease and is responsible for maintenance.

Factoring and invoice discounting: These are a particularly useful form of finance for acquisitions. Factoring involves the provision of finance via the purchase of invoices owed to a client by a bank or invoice financier. The factor will advance most of the value of the invoices on notification, with the balance remitted, when the invoices are paid by the client. The factor works on behalf of the business – managing the sales ledger and collecting money owed by customers. Invoice discounting is the same as factoring except that the client's business retains control over the administration of the sales and invoice ledger. This is far more popular than factoring as it has no direct impact on customers, although a lender will want to satisfy themselves that the borrower has good credit control. Both forms are low risk for lenders as their debt is recovered against the invoices. In acquisitions, the sales ledger of both the buyer and the seller can be assessed and a large percentage borrowed against to fund the acquisition. Invoices do, however, need to be non-conditional. In construction, for example, it is difficult as invoices often have large disputes, warranties and retentions attached to them.

Factoring and invoice discounting facilities grow with a business as its sales ledger grows, therefore it is highly flexible form of lending and well suited to growth businesses. Factoring, leasing, hire purchase and invoice discounting may be referred to generically as 'Asset Based Lending.'

Peer to peer lending: This is where individuals or companies lend directly to other companies, often via a platform which helps broker the process. Peer to peer business lending can usually be arranged faster than a bank loan. Businesses apply online which allows for applications at any time of day without the need to visit a bank. It is not a new industry. An 1898 copy of the Daily Telegraph shows the front-page half full of advertisements for such services, however, what is new is the ability to pool the money across businesses via online platforms.

The peer to peer niche works well in the UK in the gap left by the mainstream banks, with tighter regulation and lending criteria since the 2009 credit recession. Typically, loans will be restricted to £500,000 and rates will be higher than a commercial bank in order to reflect lower underwriting, especially on non-asset backed loans. In some cases, rates can also be set by the supply of capital to the platform against specific loans. There is a self-regulated body: p2pfa.org.uk, which lists lenders. Fast and easy peer to peer lending has a place although, in the UK as I write, the main rate of one of the major lending platforms is circa 10% above the base rate, whereas mainstream bank lending is circa 4-5% above base.

Mezzanine finance: Mezzanine finance is a flexible product which can be tailored to the risk and repayment profile of the business or transaction. This form of debt shares the characteristics of equity but ranks below senior (first) lending or debt. It is typically used to finance the expansion of existing companies via venture capital. As debt capital it gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in full or on time. Mezzanine finance is used in product developments, penetration of new markets, infrastructure investments or strategic merger and acquisition plans. Usually structured with low cash payments, it reduces the cash management in start-ups or fast growth businesses and so is more appropriate then senior debt.

Export finance: When businesses export, they need to be sure that they can afford to produce the goods and that they will be paid. Overseas suppliers may want to be paid for materials before shipping, so the need arises for finance to fill the gap between importing and when the finished product is sold. Traditional export finance methods include lenders offering bonds and letters of credit. In a 'bond', if the seller fails to deliver the goods or services as described in a contract, the buyer can 'call' the bond and thereby receive financial compensation from the seller's bank. In a 'letter of credit', if the buyer is unable to pay any of the entire agreed amount, the bank will offer to cover the shortfall. Both bonds and letters of credit require a fee cost, which is usually relatively low as no money is required by the funder unless things go awry.

Trade finance: This is transactional finance usually provided for specific shipments of goods and for specific periods of time. Here the asset being funded against is the goods themselves (as opposed to invoices such as in invoice financing) and until repaid by the client, the goods belong to the finance provider. The process is supported by letters of credit, bills of exchange and bank guarantees.

Debt considerations: Lenders will consider a potential borrower's personal or business credit record when deciding whether, or how much, to lend However, terms can be tailored to suit the needs of the business. Repayments are straightforward so can be simply planned for and the cash flow impact budgeted. Generally, a loan costs less in interest than an overdraft over the same term. Being locked into a rigid repayment schedule can prove problematic if cash flow is seasonal or erratic. Overdrafts are repayable on demand so they can be reduced or called in if the finance provider thinks that the business may be in difficulty. Further considerations include:

- Security against loans will almost always be required. Personal guarantees from directors and owners are also common;
- Overdrafts and asset-based finance are often quicker to arrange than a loan. Loans are less flexible than overdrafts – charges could be payable on funds not used and there may be penalties for early repayment;
- Interest is only paid on the amount of money used in an overdraft and the facility is only used if required – thereby providing flexibility. There is tax relief on interest payments;
- Leasing gives a business access to the equipment it needs without incurring the cash disadvantage of an outright purchase. Leasing is a flexible form of finance for all types of assets because the loans are secured wholly or largely on the asset being financed;
- If a business is growing, the amount of asset-based finance will track the growth.

EQUITY OPTIONS

Equity funding is 'patient money' in that it is committed to the business and its plans in both good and bad times. Its use, however, should be carefully considered as in the long-term it is not usually 'cheap' money. You need to consider several issues before selling a stake in your business in exchange for capital. Investors should also consider what protections may surround their stake and what risks are involved. Share values can go up as well as down, particularly in private companies. The main advantages of equity investment are:

- Investors and owners are aligned to secure value, growth and success on a longer-term basis. Investors may also bring expertise, contacts and drive beyond their capital;
- Investors, particularly private equity, can provide quick access to second round funding as a business grows;
- It is now possible to crowdfund equity investment which, whilst bringing its own challenges as to how to manage so many shareholders, may also lead to a deeper pot.

Founding shareholders will have put the initial equity into the business along with friends, family or 'business angels' (individual high net wealth investors). Some founding shareholders may put in loans to create a start-up. Shareholder loans, whilst not equity, may be more patient than banks. Venture capitalists or private equity investors tend to be the option for the growth phase of a business, although they will often avoid sub £500,000 profit companies. They view these as too owner-dependent and with insufficient surplus profits beyond the owners to scale up. As it progresses, a company's shareholder register will be a mix of investors who have taken stakes at different stages of its journey. Owners will be diluted and may not therefore always have the control many crave. Some find accountability to investors very frustrating, the trade-off, however, is usually larger sums of capital and money makes money.

Equity investors do not have rights to interest or to have their capital repaid by a certain date. Their return is dividend or capital value growth. Shareholder agreements are critical in equity investments. They set the rule book including, with minority investments (less than 25%), drag and tag rights to enforce sale of the shares when required. For investors in the UK, 25.1% of shares is the point at which investors secure more control with the right to veto special resolutions.

Equity investment does not usually have any security beyond the shares and if the company fails, the shares are worthless, therefore investors will spend more time on due diligence to check the opportunity and risks. They will carefully analyse past performance and forecasts and will be very focused on the capabilities of the management teams. This means raising equity investment can be more costly and time consuming than raising debt funding and ongoing reporting will be greater. The sums are, however, often much larger and for the equity investor there may also be, depending on the country, tax breaks in unlisted companies to encourage investment.

TYPES OF EQUITY INVESTORS

Many types of people invest in different companies. In floated markets the public often take stakes through pension schemes and savings. In private markets, investors range from 'business angels' (individual investors), to private equity partnerships and venture capitalists. The latter being groups of individuals established into firms or institutions with the specific aim of investing in companies. Typically, equity will seek a three to five times' return on their capital over the same period. That is, if they invest £2 million, they want to see a feasible plan that can make it £6 million or more within say five years and a dynamic management team committed to the period and with a track record of growth.

Crowdfunding has grown in recent years mainly through digital platforms but also with some specialist private equity firms raising money to invest per opportunity. Companies can potentially connect with hundreds of investors, some of whom may also be current or future customers, would-be 'angels', via an internet-based platform. With slow global economic growth investors are looking at equity to secure yield.

When taking on investment, a business should look beyond the capital investors put in. They should have experience, skills and resources, such as contacts, that will assist growth. Investors would usually seek to help improve the profitability of the business, perhaps via operational improvement. They will also expect growth via new product lines, territories and/or acquisitions.

It is important to carry out reverse due diligence on private investors and check how they will add value beyond money. They will typically seek to introduce better reporting and a more corporate management style. This is usually positive but can cause tension for highly cultural businesses where teams nurture each other, whatever their deficiencies. A corporate style tends to lead to a more 'in' or 'out' approach to employment depending on capability. Advisers can help with equity fundraising both by helping to develop the investment case and by finding and securing the right investors. Fees will typically be success-based and there will also be legal fees. It would be advisable to investigate at least:

- How much control do the shareholders want to retain?
- What percentage of equity is on offer for how much investment?
- What is the investment for, and can the company grow fast enough?
- What duration best suits the investment?
- What else does the investor offer beyond money?

Private equity fund managers usually seek to control the businesses they invest in and they will choose an optimum capital structure for each of their investee companies. This means private equity can operate with much better information and stronger controls and influence over management than funds holding quoted equities and therefore equity funding can work better on smaller companies.

PRIVATE EQUITY AND VENTURE FINANCE

Private equity starts with wealthy individuals who are active investors. Their predominant focus on ownership in the company lifecycle is on doubling or tripling the value of the company, usually over a four to seven-year period, to secure a later gain. The interest is in the shareholder value capabilities of the business as much as it is in business growth, with investors bringing increased focus, commercialisation, expertise and capability to the company; the investments are interactive rather than passive. This has proved to be a highly effective formula for both businesses and investors. Consequently, equity funds have literally grown into trillions in value. Many now also attract lower value investors and institutions that are keen to pool their money with equity firms. Today there is more money seeking effective investments than there is necessarily opportunity; super abundant capital.
The world of super abundant capital, which is a result of slow growth in economies, has further fuelled the Private Equity (PE) and Venture Capital (VC) sector. The primary difference being that venture capital will typically seek higher yields in return for higher risk on less established companies with very strong growth trajectories. Private equity yields are lower than those of venture capital but are typically still circa three times the return on shareholder value realised by an exit, perhaps with some dividend often over four to seven years as a rule.

Most of the private equity industry is now a blend of high net wealth individuals who operate in partnerships looking for a yield backed by large institutional investors, including pension funds, seeking strong return and an effective return on investment. Partners at private equity firms raise funds and manage the funds to yield returns for their shareholder clients.

The investments however are not passive, in that the investors will seek either control, or often material influence over the business model, operations and management. The investments are directly into privately held companies. The approach can therefore be thought of by private owners considering private equity as partial exit, perhaps also backed by their management team, in combination with partnership with the equity house. Business plans, forecasts, ambition, the size of the market and growth prospects become critical in the consideration for both sides, with their track record being highly scrutinised.

Because the investment is direct and a material proportion of the company is being acquired the exercise is usually only worth carrying out in larger and higher quality businesses,

Sellers often retain a proportion of shares after a buyout with the intention of a later sale at a materially 'elevated' value.

typically those already established with profits (in the UK in excess of £700,000), adjusted and normalised.

Private equity deals may also combine with 'elevator thinking'. Elevator deals are for ambitious shareholder sellers. They go beyond earn outs which are secondary payments made as growth is achieved. Instead, in this structure sellers retain a proportion of shares after a buyout; with the intention of a later sale at a materially 'elevated' value. This is often the preferred route of private equity buyers with both buyer and seller joining up to increase value, working together typically over a four to seven-year period.
Fee structures and approach vary for private equity and, as a quasi-partnership with the investor, finding the right fit requires a competitive environment much like seeking a trade sale does. Can you work with the PE partner and what is their track record? Will you stay, or will your management drive the growth and what percentage do you want to retain? These are all important questions within the private equity fundraising process. This means that employing a professional corporate finance adviser who has strong relationships with the right private equity providers is important in attracting funds. They will protect the shareholders, help prepare and represent the form, check the culture of the PE investor and structure the deal whilst you grow the business.

A spectrum of investing preferences spans across the thousands of private equity firms in existence and knowledge of this market is critical, particularly if generating competition or an auction for the investment. Also vital in the active assessment of the capabilities of the investor to add value to the venture, from increasing expertise, contacts, strategy, accountability and best practice. At the high end of company size, investment banks also become an option as active investors.

Fees of firms vary, but typically consist of a management fee and a performance fee of 2% of assets managed and up to 20% of gross profits upon the sale of the company. The industry with strong fees and yields is highly attractive to investment professionals and has therefore attracted top talent who work closely with corporate finance advisers to secure the right investments.

With so many financial professionals and funds available, the PE industry has a ruthless reputation which is unfounded. It has an important function in driving growth in economies and commercialising private companies that may become limited by the aspirations of older shareholders or their lifestyle ambitions.

For most private equity deals the analysis will be between the seller or private company and their management team, the equity investing house and the corporate finance adviser in assessing management capability, the industry, historical financials and forecasts and, as ever, conducting the valuation analysis. A fourth party may also be involved as a private equity fund will also use bank debt like any other buyer, with debt considered cheaper than equity; they will 'lever' the deal, often taking more debt than equity. Whilst an investment decision is made, due diligence, as with any trade sale, is carried out to validate the position although as ongoing dealmakers, private equity may be considered more capable and with more resources to complete deals than some trade sales. Indeed, with this advantage and trillions under investment they may also be in a position, unlike a highly strategic trade buyer, to invest greater sums and offer more than trade buyers. When combined with the potential future value elevation, private equity may prove better long term than a trade deal.

With so many financial professionals and funds available, the industry has a ruthless reputation, which is unfounded. It has an important function in driving growth in economies and commercialising private companies that may become limited by the aspirations of older shareholders or their lifestyle ambitions. This leads us to the second important function of private equity professionals: oversight and support of the equity firm's various portfolio companies and their management teams. Among other support work, they know what best practice in strategic planning and financial management looks like and can enhance new accounting, procurement and IT systems to increase the value of their investment and to drive growth. With capital behind them, acquisitions also prove to be a highly effective growth provider with a buy, build and sell capability but without the constant drag of public scrutiny that a listing might bring. The investor's management team compensation is entirely dependent on adding value to the business thus creating alignment between the investor and the management. When considering the private equity formula, we also look at multiple arbitrage (see Guide 1 : Valuations). This is where an investment is taken and made at a multiplier of profits commensurate to its size, but as the profits grow the multiplier grows so the value gain is greater than the profit gain on its own. The consequent achievement of bigger profits, higher-quality customer service, an increase in territories and line extensions may place a smaller company, which is being sold by a private equity firm, on the radar of big trade buyers and create significant value uplift to take the company to the next level. Larger companies typically command higher valuations than smaller companies.

THE PRIVATE EQUITY MODEL

BUY	CHANGE	SELL
SELECT DECISION	MANAGEMENT	TYPICALLY 2.5 TO 3.5 ROI
GROWTH POTENTION	ACQUISITIONS	4 TO 7 YEARS
VALUE PLAY	LINE EXTENSIONS	
	MULTIPLE EXTENSIONS	

Many business owners worry about selling part or most of their company. They worry that the buyer's intent is to take as much cash out of the business as possible, leaving the company they love in tatters. In the press at the time of writing in 2019, Greybull and British Steel come to mind. A tight competitive process should be run with reverse due diligence being a key part of the approach to secure equity investors in your business who are the right fit and ensure that they intend to increase the value of your company in the right way. Currently, there are over 1,250 European private equity firms, with £640bn in capital under management in Europe with only half invested.

THE PE MARKET UK

34,980
NUMBER PRIVATE COMPANIES WITH 50+ EMPLOYEES

3,000
ESTIMATE POOL OF PE READY UK COMPANIES

7,450
NUMBER PRIVATE COMPANIES WITH 50M+ TURNOVER

728
PE-BACKED UK COMPANIES IN 2018

In 2019, there are over 1,250 European Private Equity firms, with £640bn in capital, under management in Europe.

TAX RELIEF ON EQUITY INVESTMENT

In the UK as of October 2019, HM Revenue and Customs (HMRC) offers the Enterprise Investment Scheme (EIS). In order to apply, businesses must have fewer than 250 full-time or equivalent employees; less than £15m of assets and be less than 7 years old. Investors can claim back up to 30% of the value of their investment in income tax relief and they can also claim inheritance tax relief of 100% after two years of holding the EIS share. The maximum investment is £1 million.

The Seed Enterprise Investment Scheme (SEIS) is for newer, smaller companies with less than 25 employees and is even more generous to investors with a tax break of up to 50%, although the maximum investment is £150,000. Some investors also use VCTs. These are funds which qualify for 30% tax relief but invest in several companies, usually on a managed basis.

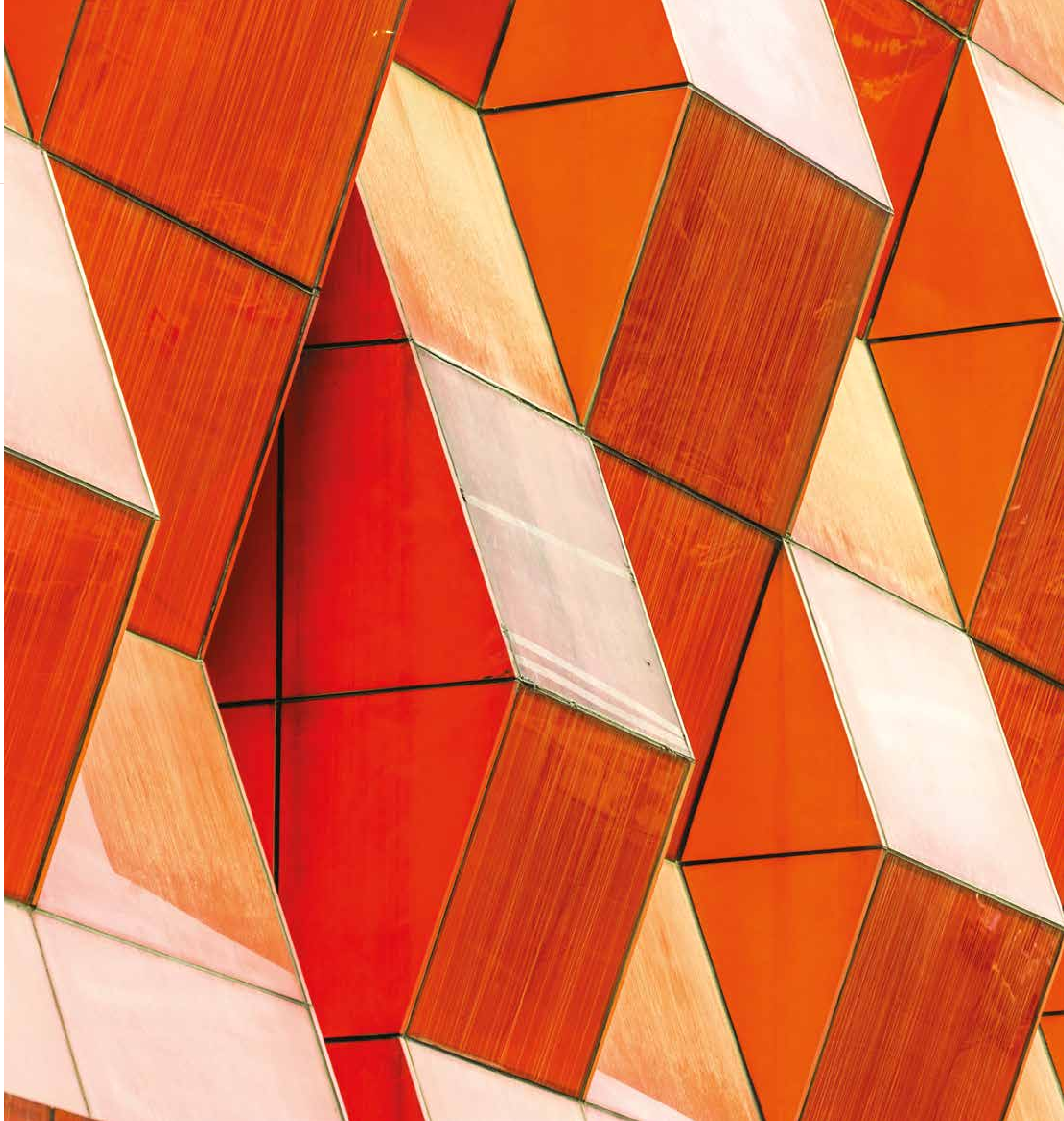
Increasingly, due to the range of options available, a roadshow and competitive bids is the best way to secure the right 'equity' deal terms

For high rate taxpayers or people with sizeable capital gains tax bills these are attractive investment breaks. Even if the growth yield on the fund's investment turns out to be nominal, the tax saving means the investor is 30%, or in SEIS 50%, up after a period when they can release the money. With every country having its own tax breaks it is well worth companies researching these as such schemes make investment beyond the business case attractive which in turn helps to secure equity funds.

Financial Engineering

The term 'financial engineering' is often used when looking at capital structure and the overall blend of equity versus debt, blending share rights and debt obligations to create the best mix of risk, reward and control between the parties. Rights issued relative to equity are also important with the strongest ordinary shares attaching dividends and a share of capital gain. A preference share however may be structured more like debt with a fixed dividend.

Essentially when we are financing, we need to look at the type of equity and its value relative to any debt offers. It is important to understand that preference structures may advantage the private equity investor to the potential detriment of management who rank behind them. Management can often end up only investing in the highest strip of a capital structure. If the yield on the loan notes or preference shares is greater than the growth of enterprise value, all equity growth flows to the private equity fund; this is called the 'equity illusion'. Management may have a high percentage of an asset on paper that in reality on sale has low value in most scenarios apart from the highest growth companies. Private equity fund raising and transactions needs careful advice.



FLOTATION (IPO)

Flotations (Initial Public Offerings) sell part or all the company to the public, giving access to ongoing public money, a liquid market for shares and typically a partial exit for existing 'private' shareholders. As floated companies are regulated and 'liquid', in that they trade daily, their valuations are higher than private companies. The listing of shares in public markets is expensive and requires significant work in a roadshow to line up investors, which is usually carried out by a NOMAD, a nominated adviser. Launching a public offering or flotation must be based on a realistic assessment of the business and its management, where it is in the stage of its development and its prospects. It should be noted that even a small sell-off of public shares needs to be orderly as investors will examine the reasons for the sell-off, particularly in smaller market capital companies and those listed on smaller exchanges.

The corporate governance and capital status of a business is tightly regulated. A strong management team and good business plan is critical. In the UK, the main public listing markets are the London Stock Exchange (LSE), the Alternative Investment Market (AIM) and the ICAP Securities and Derivatives Exchange (ISDX); in the USA, the Dow Jones and the NASDAQ. For smaller companies there are alternatives, for example, some UK companies have listed on the Frankfurt stock exchange which is currently the tenth largest stock market in the world. The first public company was the Dutch East India Company, established in 1602 and traded on the Amsterdam stock exchange. Consolidated Edison was first listed on the New York stock exchange in 1824, is still listed today and therefore the longest listed.

However, companies must have very strong corporate governance and rigorous reporting capabilities as public markets demand transparency and real-time shareholder monitoring. Public listings also increase the prospect of an ongoing change of control with investors and other companies able to acquire shares without veto. Many believe this as a 'price' worth the investment with public listing bringing prestige and usually, as a result of the listing, a material increase in the company's ongoing valuation with liquidity and transparency increasing value multiples over private companies. Further, after listing there is a ready market to secure further equity capital as a business progresses its journey.

A successful flotation usually requires:

- A sustainable and consistent financial performance with a sound balance sheet and very carefully designed systems, checks and controls to meet the regulatory and reporting demands of public markets;
- Investor relations' capability, a mix of regulatory and voluntary activities to create transparency and interact with both markets and stakeholders;
- Good growth prospects and a management team which can demonstrate a solid track record and good knowledge of the market, the opportunities, threats, weaknesses and risks;
- A highly detailed prospectus and process with a comprehensive plan setting out the products, markets, competitive environment, strategy, capabilities and growth objectives of the business;
- Carefully crafted financial and risk modelling, along with clearly explained outputs for the capital raised and its ongoing utilisation;
- Strong legal and administrative capability with rigid corporate governance systems and arrangements.

Flotations have reduced in volume in recent years as the costs have risen along with regularity demands. The advent of increased private capital, particularly via pooled investors such as private equity, bring some of the same advantages. Many academic analysts are critical of this. This is because as a result of private equity investment, there are today several highly significant private tech companies which would benefit from the increased transparency of a listing in their interactions with markets and their customers. Today these include Pinterest (online content sharing) and Airbnb. Airbnb (online accommodation) is valued at $31 billion.

A public listing can increase a company's profile and further, allow it to use its shares as an acquisition currency, creating a real time valuation as its shares trade daily and give real incentives to key employees through share option plans.

FUNDING ACQUISITIONS

Acquisitions can propel companies to competitive advantage faster than organic growth can achieve; carried out well, they can grab headlines and secure 'CEO saviour' or leader reputations; carried out badly they can destroy value and create 'CEO scoundrels'. The method chosen to fund deals may also have a material bearing on success. Even if a company has the cash reserves to do a deal, leverage or debt may still be cheaper when firms look at the internal rate of return they can secure on that money from investing in organic growth, therefore debt may be considered appropriate for acquisitions. This will require modelling and analysis.

Value can be gained by working with specialist lenders to secure the right debt. The cash lifecycle, work in progress and headroom need careful modelling to understand the prospects for funding and serviceability of debt whether capital and/or repayment. Analysis of a carefully prepared forecast profit and loss account and balance sheet and then, crucially, the cash flow, allowing for seasonality of the proposed combined entity, will be required. Genuine and demonstrable synergies and adjustments will be allowed via lenders, but they require careful explanation and presentation against the wider acquisition business plan.

BUYER CASHFLOW + ADJUSTMENTS
+
SELLER CASHFLOW + ADJUSTMENTS
+
+IMMEDIATE SYNERGY
• LESS TAX
• LESS WORKING CAPITAL
• ALLOW FOR SEASONALITY
=
HEADROOM FOR DEBT
REPAYMENTS SUBJECT TO GUARANTEES, CREDIT AND ASSET BACKING OR CASHFLOW LOAN

CONCLUSION

Professional corporate finance advice and analysis along the business journey is critical, particularly if acquisitions are required, in order to gain advantage, synergy and develop shareholder value. Advice should combine with a wealth of contacts from lenders to investors and equity providers with experience of all the options and industries.

The process of creating an optimal capital structure for a company is called financial engineering, answering at a simple level how much it is prudent or possible to borrow from a bank. A capital structure is in practice more complex than simply an amount of permanent equity (ordinary shares) and a bank facility. The structure will have to be enough also to finance the business plan of the company, which in a buy-out includes financing the acquisition and the associated acquisition costs. It will also need to have the headroom and be flexible enough to cope with market volatility. It should be efficient, minimising unnecessary taxation as well as currency and interest rate risk. It also has to accommodate the need to incentivise key management and staff at the same time as rewarding the other investors for the risks they are taking.

Overall, the more 'unsecured' assets that are available, particularly property, the more scope to 'secure' any loans a lender will have and therefore the lower the risk they may face, as in the event of default the lender has the asset to 'close' on. As loans are more secure, the risk is lower to the banks and therefore usually they will charge the borrower less. This lower cost in turn increases the ability to service higher debt and therefore borrow more.

Finance is an essential component of competitive advantage as are acquisitions. It is important to assess the options but also to be objective about your own and your board's personality. There are many successful businesses which have ridden storms to reach success with owners who are risk-adverse sailors. At the same time, entrepreneurs in start-up phase forget the analysis as their dream becomes an obsession. Like all things, finance requires balance and awareness which means research, study and assessment. Reporting can also have a major bearing. Many entrepreneurs run their business by the bank balance, which is no bad thing, however, they may miss opportunities as a consequence and furthermore can fail to understand the true nature of the business as their systems fail to 'red flag' eroding margins, or an increasing order book which may require additional working capital.

In many smaller companies the Financial Controller is a bookkeeper and credit collector and certainly not a Finance Director. In large corporates the role of Finance Director is also increasingly combined with that of shareholder value architect; that is, they are engaged in activities to enhance value as well as track value.

A common misconception is the idea that securing shareholder value requires near-term decisions that boost share value. Instead it requires a focus on cash flow as opposed to profit earnings and managers who take risk into account on their capital decisions with a long-term approach. The right finance methods, relationships and partners support the journey. There may seem a complex spectrum of solutions but there are only two basic elements – debt and equity; each with only a few specific sub-sets. It is the blend of all that can make financing seem complex, but we must also remember there are only two basic sources of financial return: yield (or income) and capital gains (or wealth creation/loss).

Fundraising may be a chore, but it can add value. Modern enterprise combines the best business model with the right capital, debt and ownership structures central to business success.

Each funding approach should be tailored to the optimal solution for your needs; appropriate, attainable and with the risk carefully considered.

There are only two basic sources of financial return: yield (income) and capital gains (wealth creation/loss).

Business Sales | Acquisitions | Corporate Finance | Strategy

WHY AVONDALE ARE DIFFERENT

- **Our expertise:**
  We are a team of creative, experienced and candid experts that challenge, create impact and provide you with best advice
- **Our authenticity:**
  We have a strong relationship-led ethos; and we always deliver
- **Our agility:**
  We offer flexibility enabling a bespoke approach to match our clients' needs
- **Our partnerships:**
  Championing clients' needs combined with intelligence and resource
- **Our technology:**
  We have global capability via a highly developed research platform, AI matches and virtual data rooms
- **Our strategic thinking:**
  We anticipate and challenge ahead to create fresh perspectives and leads

AUTHOR

Kevin Uphill
Chairman
kevinuphill@avondale.co.uk

CONTRIBUTOR

Tim Hardman
Managing Director

See also:
Guide 1: Valuation Methods and Multiple Arbitrage
Guide 2: Employee Ownership Trusts
Guide 3: Exit Strategies by Design
Guide 4: Acquisitions

Avondale is a leading Mergers & Acquisitions strategy consultancy. We have been working with the best entrepreneurs and companies operating both locally and globally for nearly 30 years.

Our firm provides a fully integrated service from business sales and acquisitions to business growth and strategy to corporate funding opportunities.

Our expertise, combined with ambition, insight and vision, creates value and delivers excellence.

CONTACTS

HQ: REIGATE, UK
Chapter House, 33 London Road,
Reigate, RH2 9HZ
Phone: +44 (0)1737 240 888
Email: av@avondale.co.uk

LONDON, UK
8 St James's Square,
London, SW1Y 4JU
Email: av@avondale.co.uk

BUDAPEST, HUNGARY
Avondale Central
III. Emelet
Lajos Utca 66, Budapest, 1036
Phone: +36 70 866 5224
Email: av@avondale.co.hu

Visit www.avondale.co.uk for other Guides in the series

AVONDALE