SWAAB

A PRACTICAL GUIDE TO PRIVATE EQUITY FUNDING FOR COMPANIES SEEKING INVESTMENT

A COURTESY GUIDE PREPARED BY SWAAB ATTORNEYS

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Overview of Private Equity

To put it simply, a private equity fund generally buys or invests in a company with the intention that it will improve its earnings or value by providing capital and expertise and then sell the investment at a profit. The profit is eventually distributed to the people who have invested in the fund.

Fund is jargon for a *unit trust*. The investors in a private equity fund are mainly institutional investors such as life insurance companies and superannuation funds. The funds are called *private* equity funds because they invest in non-public, unlisted, (ie. private) companies. They are called *equity* funds because they invest in equity (the jargon for an investment in shares as distinct from property or financial instruments).

The funds are run by *managers*, usually on the terms of an investment management agreement and subject to the terms of the trust deed forming the fund. The fund manager receives a fee from the fund which typically includes a performance fee based on the *return* achieved by the fund on its investments. The decision to make an investment is usually made by the fund manager, subject to approval from its *investment committee*.

Private equity funding is used by companies of all sizes, to provide the funds for start-ups (where the funding is sometimes referred to as venture capital), expansion capital, management buy-outs and public to private deals.

Where a company requires *expansion or development capital*, the private equity fund will subscribe directly for shares in the company.

In a *management buy-out* the private equity fund will typically team up with two or three of the existing senior managers of the target company, and those senior managers themselves participate in the purchase. The private equity fund and the managers will invest in a new company (the fund will usually subscribe for about 95% and the management team will subscribe for about 5%) and the new company will then acquire the target company (see structure diagram on page 2).

The acquisitions are usually completed using borrowed funds (together with private equity investment funds) to increase the potential return for investors. Where borrowed funds are used, this is referred to as *leveraging* the transaction. Most of the borrowed funds will be provided by a bank (*senior debt*). Further loans (known as *mezzanine* or *junior* debt), may be provided by another financier. These loans are subordinated to the senior debt but rank ahead of any funds provided by the private equity investors. The private equity fund may also make part of its investment by way of loan funds (called *subordinated* debt), which will rank below all other loan funds. Subordinated debt may also be convertible into equity (for example, by way of convertible loan notes) on the occurrence of certain events.

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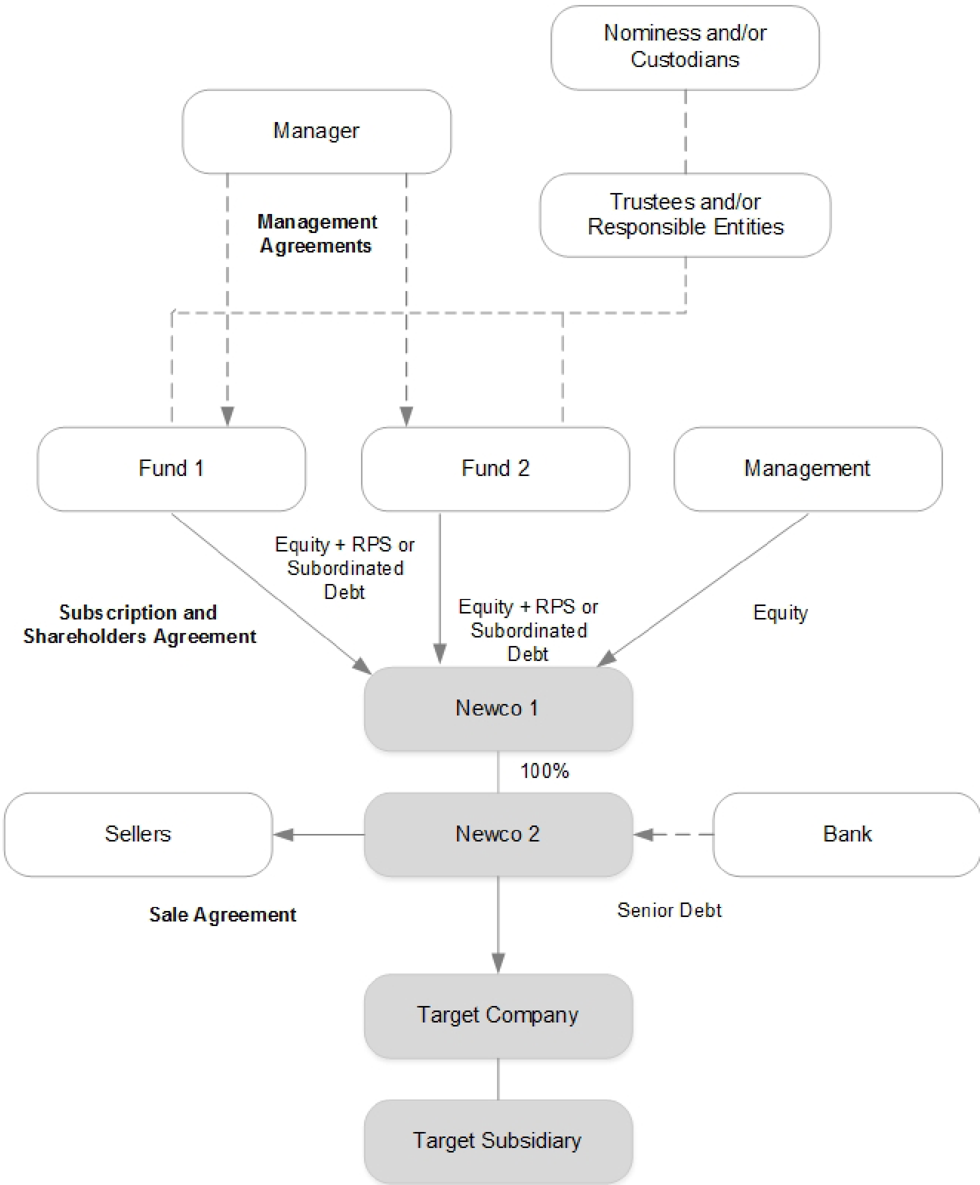
An exit is a transaction where the private equity fund sells its investment. The exit usually takes the form of either a sale of the company to a third party buyer or a flotation of the company on a stock exchange (IPO) together with a share buyback. An IPO involves the raising of money from applicants subscribing for shares under a prospectus, where some or all of the money raised is then used to buy back the shares held by the private equity fund in the company.

Private equity funds are usually set up with a lifespan of 10 years. This means that investments are cyclical with an initial set of investments after the fund is set up, then several exits after 3 or 4 years, followed by another set of investments. As the market matures many of the entries and exits are *secondary buy-outs* which is where one fund buys the shares (equity) of another fund.

Management Buy Outs

A typical management buy-out structure might look like this:



See note on Fund Issues on page 5 in relation to **Trustees, Responsible Entities, Custodians and Nominees**

Equity means shares

Senior Debt means amounts lent by a bank and repayable ahead of all other creditors

RPS means redeemable preference shares (a hybrid of debt and equity which carry a preferential right (usually to a dividend) and which can be bought back by the company)

Sub Debt means subordinated debt (amounts lent by shareholders or institutions which are repayable only after the senior debt has been repaid in full)

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Pros and Cons of Private Equity Funding

ADVANTAGES FOR A COMPANY

- Faster growth
- Unsecured finance
- Employee ownership (in the case of MBOs)
- Strengthens financial position
- Assists with obtaining other forms of finance
- Funding committed until exit (unlike bank loan)
- Management and relationship advice

DISADVANTAGES FOR A COMPANY

- More complex accounting and reporting
- Investor veto rights
- Accountability to investor
- Investor board involvement
- Restrictive covenants for managers
- Warranties to be given by managers
- Investor is exit driven

Thoughts on Business Plans

Private equity investors will expect to see a business plan relating to the company seeking funding. The business plan will be a key factor in establishing credibility with investors.

It is a good idea, as part of the process of preparing a business plan, to carry out a legal audit of the business to ensure that all assets are held legally, corporate records are accurate and any licences required to carry on the business are in place.

To the extent possible, commercially sensitive information should not be included in the business plan, to reduce the risk of this information being made available to competitors. Recipients of the plan should also be asked to sign a confidentiality agreement, sometimes called a non-disclosure agreement (or NDA), in advance.

The business plan should include the following information:

LEGAL

There are specific legal requirements relating to the raising of funds by issuing shares. Before a business plan can be distributed with the intention of raising funds from the public, certain requirements must be met in order to comply with the financial services legislation and a special legal 'health warning' should appear prominently in the plan.

CONTACT DETAILS

A list of contact details for directors and advisers to the company.

EXECUTIVE SUMMARY

A summary of the main points in the business plan.

CORPORATE INFORMATION

Details of the company's officers, shareholders and advisers.

HISTORY AND BACKGROUND

A summary of trading history, achievements and changes in ownership.

PRODUCTS AND SERVICES

Details of operational activities, the workforce, key suppliers, insurance cover and intellectual property rights held by the business.

MARKET

Details of the market in which the business operates, any barriers to market entry, marketing and advertising strategy and competitors. Also details of major customers (including key personal relationships), key target customers and sales and marketing resources.

STRATEGY

A summary of the company's objectives and strategy to achieve the nominated targets.

DIRECTORS & MANAGEMENT

This section should include profiles of the directors and key managers, details of their service contracts, any shares or share options held by them and any outside business interests.

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FINANCIAL INFORMATION

- Historic performance since incorporation
- Profit and cash flow forecasts for the next three years
- Assumptions on which forecasts are based
- Break-even analysis
- Pro-forma balance sheet showing structure immediately following the investment.

USE OF FUNDS

Details of the amount of funding required (and when it is required), the intended use for the funds and details of any existing borrowings and borrowing facilities.

FINANCIAL CONTROLS

Details of approvals required for expenditure and a summary of the ongoing financial information to be provided to investors.

INVESTMENT TERMS

- Valuation of the company and shareholding to be acquired
- Form and mix of finance (equity, loans or redeemable preference shares)
- Anticipated schedule for repayments of loans or preference share capital
- Anticipated level of management participation by the investor
- Proposed exit route for the investor.

RISK FACTORS

These might include:

- Market conditions
- Changes in legislation
- Transactional and operational risks
- Reliance on key personnel, customers or suppliers
- Competitors.

ANNEXURES

The following documents should also be included as part of the business plan:

- Latest audited accounts
- Latest management accounts
- Profit forecasts and assumptions
- Cashflow forecasts and assumptions
- Pro-forma balance sheet following the fundraising
- CVs of directors and key employees
- Company brochures
- Marketing material.

Common Issues in Investment Documents

INVESTMENT DOCUMENTATION

The documents which might be involved in a private equity transaction include:

- Business Plan
- Confidentiality Agreement
- Exclusivity Agreement in favour of a specified investor
- Equity Terms Sheet
- Due Diligence Reports
- Share Sale Agreement
- Disclosure Letter
- Subscription Agreement
- Shareholders Agreement
- Constitution
- Intercompany Loan Agreement
- Senior Loan Facility Terms Sheet
- Senior Loan Facility Agreement
- Security documents
- Intra-group Guarantees
- Inter Creditor Agreement / Subordination Deed
- Loan Note Instrument / Subordinated Loan Agreements
- Service Agreements for the executive directors
- Deeds of Access, Insurance and Indemnity for the directors
- Tripartite Deeds (between the bank, a landlord and the company to allow the bank to step in and continue trading the company where the company fails to pay its rent, before the landlord repossesses the property)
- Deeds of Assignment of various rights
- Consents from any material customers or suppliers
- Tax Sharing Agreement and Allocation and Funding Agreement (to deal with the allocation of liability for tax in a consolidated group)
- Minutes of meetings and other company administrative documents

FUND ISSUES

When dealing with private equity funds, you may come across a number of unusual entities which are related to trust funds.

A *trustee* is the entity that holds investments or property on trust for the beneficiaries of the trust (commonly institutions that have invested funds in the trust). Duties are imposed on the trustee by statute and case law to ensure that the terms of the trust are carried out and that the trustee acts prudently. The trustee also owes fiduciary duties to the beneficiaries.

A *custodian* may be appointed by a trustee as its agent to hold trust property on behalf of the trustee to assist it in carrying out its duties. A custodian would normally be bound by a written agreement to act on the directions of the trustee and would look to be indemnified by the trustee for any liabilities that the custodian may incur as a result of acting in accordance with the trustee's directions.

A *nominee* holds property on behalf of another. A nominee is similar to a custodian but usually has more limited ongoing obligations. Nominees are typically used where a person wishes to conceal their identity (for legitimate purposes).

A *responsible entity* must be appointed over a fund, where units in a trust are made available to the public. Under the Corporations Act 2001, the trust must be a registered scheme and the trustee must be appointed as the responsible entity. A responsible entity is required to hold an Australian financial services licence and is regulated by the Australian Securities & Investments Commission.

DUE DILIGENCE

This is the detailed evaluation of the target business by the investor. Due diligence involves the submission of written enquiries relating to the business, a review of the company's documents and contracts and interviews with management. The information collected is usually used to prepare one or more due diligence reports relating to the business, which highlight areas of risk. There may be several reports, each of which deal separately with legal, accounting, insurance and environmental issues.

The investor will use the reports in the sale negotiations by trying to adjust the price or obtain warranties or indemnities relating to any material issues identified in the reports. The fund manager may also show the reports to its investment committee and to the bank providing finance for the acquisition.

SALE ISSUES

The following is a list of some of the contractual provisions typically found in sale agreements relating to a management buy out:

Purchase Price

- Completion balance sheet to provide for final figures
- Net asset and/or working capital adjustments

Conditions Precedent to Completion of the Acquisition

- No material adverse change
- Receipt of consent to sale from landlord / customers / suppliers
- Production of agreed form or signed documents (eg. service agreements)
- Satisfactory finance arrangements put in place by the buyer
- Receipt of regulatory approvals (eg. ACCC, FIRB)

Warranties and Indemnities

- Warranties are used to extract information from the target company, to protect against undisclosed liabilities and as a risk sharing and price adjustment mechanism
- Indemnities are used to protect the investor from specific liabilities

Restraint of Trade

- Important in manager-owned businesses to prevent managers from leaving and setting up in competition

Financial Assistance

- Usually where a bank takes security over the assets of the target group in exchange for lending funds to the investor to acquire shares in the target.
- General prohibition on giving financial assistance, but permitted in certain circumstances

TAX ISSUES

- Stamp duty (this is now calculated on the total consideration, including for example an agreement to repay debt, rather than just the purchase price)
- Newco incorporation should be in Victoria (so there is no stamp duty on share transfers)
- Mortgage duty (if applicable)
- Land rich duty (payable on the amount paid for shares in a company which is land rich)

SHAREHOLDER ISSUES

The following is a list of some of the issues that arise in negotiations on the shareholders agreement:

Management of Company

- Level of board representation for the investor
- Veto powers for the investor on critical business matters
- Step-in rights allowing the investor to assume control in certain circumstances
- Amount of financial information to be provided to the investor
- Conflict of interest for management in relation to their fiduciary duties and their duty of confidentiality to the target (in an MBO, the managers will be directors and employees of the target as well as directors and shareholders of the buyer company)

Management Remuneration

- Service agreements (remuneration, notice periods, termination provisions)
- Incentive / bonus payments (performance and exit based)
- Ratchets (increased equity for managers where certain performance criteria are met)
- Sweet equity (managers pay lower subscription price for initial equity stake)
- Options

Share Transfers

- Pre-emption provisions on the sale or issue of any shares (subject to permitted transfers)
- Tag /drag along rights
- Compulsory transfers on cessation of employment with the company (with reference to the status of the shareholder as a good or bad leaver)
- Compulsory transfer of shares on a change of control of shareholder

Warranties

- In an MBO, the management may be asked to repeat the warranties given by the seller in the acquisition agreement
- Management may be asked to warrant the assumptions behind the business plan

EXIT FROM INVESTMENT

Private equity funds usually have a 2-5 year cycle for exits from each investment. The lifespan of a typical fund is 10 years. Exits will almost always be by one of the following methods:

- trade sale (and distribution of proceeds to shareholders)
- share sale
- secondary buy out
- IPO and share buy back.

If a company has been unsuccessful, the exit may be by winding up or a low value transfer of the investor's shares to the managers or the financier.

Why Private Equity Funds Might Decide Not To Invest

INVESTOR WISH LIST

From the investor's point of view, the transaction may not be attractive if any of the following issues are not resolved to its satisfaction:

- Potential for capital growth
- Confidence in management
- Financial commitment from management
- Fair executive remuneration
- Fair slice of the equity
- Board representation
- Control over important business matters
- Regular financial information
- Restriction on dividend payments
- Agreement on use of funding
- Restrictions on transfers and issues of shares
- Restrictions on managers competing with the company
- Protection of company's intellectual property
- Exit strategy
- Investment costs paid by target
- Compensation if information relating to the company is not accurate.

MANAGEMENT WISH LIST

From the managers' point of view, the transaction may not be attractive if any of the following issues are not resolved to their satisfaction:

- Right to continue to conduct day-to-day business
- Certainty of employment
- Fair executive remuneration
- Performance incentives
- Limits on warranty liability
- Protection of minority shareholder rights.

EXAMPLES OF KEY PROBLEMS*

- Lack of confidence in management
- Level of costs in proportion to the amount of the investment
- Insufficient prospects for growth
- Level of control required by the investor

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- Amount of time required to finalise the transaction
- Problems discovered with major contracts during due diligence process.

*These problems can generally be avoided by preparing a detailed business plan in advance to respond to due diligence enquiries by the investor and reaching a clear agreement on the main terms of the investment.

CONTACT US

The corporate team at Swaab Attorneys is committed to working with companies to help them meet their ambitions. If we can help you with any of the issues raised in this Guide, please contact Alistair Jaque. We would be very pleased to discuss any issues with you.

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This Guide is only intended to give an overview of the issues involved. It is not intended to be fully comprehensive or to be a substitute for legal advice.

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