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Private Equity

A fresh look

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A private equity lobbyist runs into a banking lobbyist in the street. "Oh, thanks," he says. "For what?"the banking lobbyist asks. "For diverting all the bullets which were being shot at us," replies the private equity lobbyist.

Invariably the headlines had been all about asset stripping, how private equity houses over-leveraged companies to the point where they had so much debt they were, in effect, set up for failure should the merest breeze waft through the economy. The days of using financial engineering, in other words significant debt, as a means of generating a return for private equity houses have probably gone.

The future for private equity is to achieve it from growing a business and in truth, that's the model most private equity houses working in the real world, as it were, have always adopted.

Part of the problem is the considerable confusion that exists between private equity and hedge funds. The two have often been viewed as synonymous when, in fact, they are quite different in fundamental ways.

Typically, private equity is a four to five-year investment based on working with the company executives in order to create additional value. Hedge funds, on the other hand, tend to be much shorter-term (six to eighteen months), are more speculative, with generally little knowledge of the target company and its management, and less regulated.

Arguably the origins of private equity in this country can be found in the formation of the Industrial and Commercial Finance Corporation at the end of the second world war to invest in companies which couldn't get sufficient funding from the banks but were too small to turn to the stock exchange. Of course ICFC has morphed into what is now 3i, a public company which then positioned itself in the higher echelons of funding.

According to Mark Florman, chief executive of the British Private Equity and Venture Capital Association, 90% of senior managers in companies which have private equity investment say that it has benefited their businesses. "Value creation should not be piece of jargon," he says, "but a definable, understandable concept that goes to the very heart of what private equity sets out to achieve."

And with mergers and acquisitions funding and capital for growth hard to prise from the banks, private equity is an option that more companies are going to have to look at afresh.

Why the owner can still come with

"I think there's confusion about private equity at a number of levels," says Andrew Hayden, managing partner of Sovereign Capital, "but it starts with the different types of involvement, from institutional buy-outs, management buy-ins, to investment capital, all of which are covered by private equity.

"The owner-manager whose business has been part of their family for many years, will understandably want to leave it in safe hands and will worry about the new owner imposing a completely different set of values and culture. But those concerns will be the same if the new owner is a trade buyer, who could be a competitor, or if it's private equity.

"I believe a private equity house has to be able to talk to an owner-manager at an operational level, as a knowledgeable buyer, not just a source of finance. The owner-manager also wants to see that we buy into the ethos of the business, and that we will develop the potential of their team.

"The result is that the vendor gets a good price, the management team an opportunity, and the business the capital to take bigger steps forward. The ambition of a private equity house is going to be greater because we'll be looking to double or treble the size of the business. We've got the firepower and access to management resource that will be beyond the owner-manager. But of course the owner-manager could come with us on the ride and keep a percentage, which we have done on many occasions."

As well as bolstering systems. "For most owner-managed businesses, KPIs are intuitive, but they have to be properly introduced as a discipline, together with the rigours of a reporting mechanisms," says Hayden. "Effectively we're corporatising a company.

"From across the companies we have invested in, we bring the CEOs, finance directors, and operations directors together in a forum setting to share 'best in class' knowledge, so in that respect we're a bit like a holding company trying to improve individual businesses with collective knowledge. We've also set up a buying group which our companies can use.

"Private equity also gives individuals the chance to have a stake in the company rather than just being an employee. We might give the divisional finance director from a corporate environment the opportunity to be CEO of a company which they will have a stake in - so not only will they lead it, but they'll benefit financially from its success. Private equity is the enabler; we can make it happen."

"After Lehman," muses Hayden, "private equity deals have been typically 60% equity and 40% debt, which can make a dent in returns. But if the focus is to create value through robust growth, as ours is, the availability of debt should have less of an impact."

Which is why Sovereign likes to provide serial funding for companies to implement a buy and build strategy, to be a consolidator in their market sectors - to roll out the business model. "Acquisitions can be a catalyst for generating better organic growth," says Hayden. "As our partnership with the management team grows, then it makes sense to continue to invest in them to achieve more rather than starting again with a brand new team elsewhere. Certainly there's less risk.

"Our role is not just to be strategic but to find potential acquisitions. Management will handle the operational due diligence, and if they don't completely buy into it, then we won't force them into making the acquisition.

"Historically a lot of acquisitions have faltered or failed to happen because the owner-manager who wants to make an acquisition is diverted from their business by the process. A private equity house will take that strain away by handling the M&A and corporate finance. With private equity, companies also have the financial firepower to be more opportunistic. For example, within a week of our investing in a drainage business, their major competitor went into administration and we acquired the business. The owner-manager of the company we'd invested in wouldn't have had the financial firepower and perhaps the courage to do it left to himself."

Hayden accepts that the good leaver-bad leaver provision in the service agreement and the impact on the value of the shares held by the director in question is an elephant in the room for the management team. "You can spend hours in the legals, but the only way forward is on a basis of trust," he suggests. "Talk to any of the management teams we've invested in and ask if they have been shafted."

Which is exactly what Christopher Allner, head of private equity at Downing LLP will suggest. "We try to get an entrepreneur to talk to other companies in our portfolio, so that they can take references," he says. "They very rarely do though, which I find extraordinary."

Carry on but not as before

"Absolutely private equity is a step change," stresses Peter Hodson, investment director at NVM Private Equity. "A company doesn't do the deal and carry on as before. There can be a change of direction into new markets, an acquisition - it's much more about the dynamics. I don't think there is anything wrong in requiring a demonstrably good management system that delivers a clear, well-thought out strategy and creates market presence which makes that company more valuable in the marketplace as a strategic purchase for a larger player.

"Private equity involvement brings a fresh perspective. Companies get used to doing things the same way, and while the approach they have adopted isn't necessarily bad, there needs to be impetus for fresh thinking. Very few private equity deals are to fund organic growth. The thing about private equity is that we're all shareholders. It isn't a confrontational relationship because that would harm value.

"One thing that private equity can bring in addition to a new perspective is an understanding based on experience of where something can go wrong; we can identify the signs. After companies put in a new management information system, you'd be surprised how many are close to falling over because the installation process means they lose control of cash management.

"What also reduces the risk is for a company to have the right number two for each executive role, just in case someone goes under the proverbial bus.

"It sounds trite, but I would suggest that the purpose of private equity is to make their shareholders' investments as valuable as possible. I don't think the owner-manager has much time to spend on shareholder value and how it can be achieved. What we bring as private equity investors is rigour in analysis to identify what can be achieved, and discipline in process to get there. What it means is that the fundamental of shareholder value is always front of mind. The point I'm making is that the only way we can succeed is if our portfolio companies are successful.

"I think that private equity investment gives the owner-manager confidence. Good entrepreneurs can't stay still, but even if they recognise that an acquisition is necessary to take their business to the next level, if they haven't done one before it can be a lonely decision.

"An owner-manager might have been running the business for the last decade, now with a £20million turnover and £2million pre-tax profits, but what he or she might not realise is that the closer they are to the business, the less chance they will have of walking away after say a trade sale, because they will have to be locked into the deal.

"Private equity is a label which covers the buy-out of an SME to a £5billion global deal with 70% debt funding. My view is that if there is a major global asset which is undervalued, and it is possible to raise capital to acquire it, then nobody is committing a crime, but that's not the market we are in. Ours is about looking for growth, and we're not driven by financial engineering.

"The vast majority of companies don't need £5million to grow. Usually conversations are about £ $^1/_2$ million because a facility has been reduced by their bank or an increase has been refused. If companies with potential are capital-constrained now, it has to mean there won't be so many coming through because of the equity gap. Dotcom virtually killed the venture capital market. Now it's the banks, high-worth individuals, or nothing.

> "Entrepreneurs for private equity to back are those with energy and ideas but who understand the importance of due diligence and process; they know that the business is not their personal plaything."

The unspoken impediment

According to Martin Rowland, an investment director at Lloyds Development Capital, the question of who is then in control after private equity investment can be an unspoken impediment.

"We're asking the owner-manager to give up a degree of control, and for some that feels like selling the family silver, which is an understandable reaction," he suggests. "That isn't helped by media portayal which has painted a picture of private equity as asset strippers, financial engineers, with one or two individuals making money at everyone else's expense.

"Private equity needs to articulate why companies can benefit from its involvement and support. It's not about leveraging businesses up as much as possible, getting them to pay off that debt and then selling to get the value. We want to make a business grow to deliver value which it couldn't achieve on its own, such as by making acquisitions which their bank might not want to fund.

"Private equity can also help companies cash up their old shareholder base. There was a family-owned business which talked to us because it wanted a better balance sheet, not capital, in order to be in a position to attract bigger contracts and to de-risk the process of some of the shareholders getting some cash out. The point I am making is that private equity is flexible."

That said, there is a definite focus on planning and process once private equity is involved. Which means, says Rowland, that the resources in a business tend to be deployed more effectively. "But without vision," he points out, "there's nothing for private equity to back.

"We're interested in operational improvement rather then operational involvement; how we can support the management team in procurement, outsourcing, routes to markets overseas, pricing. It's about being active, mot passive, backing rather than running; we're not saying this is what you need and you're going to have to do it.

"We want to work with people who recognise that something else is needed to really move their business forward, and that input has to come from an outside source."The best CEOs are those who are prepared to look at opportunities which would require capital and who realise they need to have good quality management to complement what they are doing. Private equity will also help them to clarify their thinking, but it comes at a cost.

"A criticism of private equity is that looking at four to five years is short-term, but in fairness, when owner-managers are looking at timelines, it can be very much about whether they did better this year compared to last.

"We aren't here to kill businesses by imposing unnecessary procedures, and we're not attempting to corporatise them by adding layers of process. Our emphasis is on capitalising on the ethos which made the business attractive to private equity in the first place. But there has to be a discipline in providing financial information, the kind of numbers that a subsidiary would be used to providing."

And Rowland doesn't flinch from addressing what happens if something goes wrong. How will the private equity house behave in terms of the good leaver-bad leaver provisions? Will the directors lose wealth because the company had a couple of bad months? "What I can tell you," says Rowland, "is that for a private equity house it's a major disaster to have to change management teams. Fundamentally we have the belief that the people we invested in will turn things around. But if a business is tanking, everything is evaporating and the clock is ticking ever faster, then an investor is going to have to take the risk of making changes.

"My advice? It's been said before - ask a private equity house to let you talk to directors of companies they've invested in to reference their response to your question about what would happen in adversity. To con people and take away their equity isn't a sustainable model. We want to see management fight back when the chips are down. But in a disaster scenario, the management team's equity isn't going to be worth much, or anything.

"If the management team is confident, they shouldn't be concerned about that provision. After all, banks will have covenants in place, and that will be their focus; a private equity house will want to ride out volatility with the management team because they're both in the same frame."

Rowland doesn't believe that private equity will be broadening its repertoire to fill the funding cap caused by the bank credit freeze. "I don't think we're seeing private equity moving into the space where a venture capitalist would be expected to be - the small business, two or three years in with good potential, looking for up to £1million. That isn't a sweet-spot for private equity," he says.

Exciting in the right sectors

"Private equity wants to back exciting businesses in the right sectors with the ability to grow at 20% a year, because however good a team it is, if the outlook for the sector is flat, it's tough,"

says Christopher Allner, head of private equity at Downing LLP.

"The entrepreneur at a company with that kind of potential is often a dominant person who doesn't have the complete skill set, and won't always see the value of investing in a finance team. When we come in we normally have to strengthen that function, and then a few months down the line, the owner will realise that they are finally getting the right data at the board meetings in order to drive forwards.

"Often the sales pipeline has no structure either – the company will focus on the big deals and won't efficiently manage their sales prospects across the board. They can get carried away when they get a whiff of a major contract. For us it's all about proficient management.

"We also find that the entrepreneur is quite instinctive. When a company is turning over one to two million, that's fine, but when it grows, and the guy at the top becomes more divorced from the customer, he doesn't have the same feel for what is going on. When we go in, often it's often the first time the company has experienced due diligence and market research. It can be quite a painful experience for them – but so worthwhile. They don't think it's needed, but the research will usually come back with findings that the owner never realised, and which they can use to make it a stronger business.

"We've never relied on very high levels of debt so, for us, the returns come much more from the growth of the company than de-leveraging. My own view is that the banks have been remarkably good compared to the nineties recession. They've not been pulling the rug. They were so over-lending to small businesses though, that they will never go back to that point – or not in my lifetime. We haven't been seeing the banks much at the moment.

"The biggest problem is that companies are going to want to grow, and there's no equity. I think what we will find in the next year or so is that there won't be so many companies growing to a size which would attract the PE market.

"As investors, we believe that we are more engaged in an entrepreneurial company as it goes through its childhood and teenage years. We can help it develop a mature and balanced management team, so that they have a more enhanced value when they sell the business. Generally they won't have a strong sales team, or a fully refined business model – they need to develop that infrastructure and usually need help. We bring that to the table which is what leads to the

enhanced value at exit. One of our companies was pitched recently and the advisors said that they saw it as a better-run business because of the PE investment.

"If there's a good deal on the table there are plenty of people in the chase. You can't look at a data index to value a business – it's not meaningful anymore. To be able to price the risk, the private equity house has to understand the business better. It's a tough market for PE right now. A lot of people have grown up in this sector with a fairy easy ride, but today you really have to know what you are doing to get it right.

"I accept there is a lack of expectation about what PE can do for a company, but then the entrepreneur, instinctively, isn't always willing to take advice. We look for the ones that we think we can work with. When we first sit across the table from entrepreneurs we can see they're thinking, 'what does he know about my business'? Entrepreneurs doesn't necessarily see it as an opportunity to take on a partner who will share the downsides and the upsides – they don't expect the downsides!

"Maybe we have to show a bit of humility. We don't know as much as the entrepreneur about their business because they live and breathe it. Building a rapport is very important. We need to find out what their exit plans are and make it clear that we can have the same end game. It's about understanding the individual and building empathy, and it's important for us to be passionate about their business too."

Add the art of the possible

A point taken up by David Menton, a managing partner of Synova Capital. "In real terms, a company is nothing more than a few legal documents and certificates. It's actually about the people, the product, the service," he suggests. "Our focus is on instilling financial discipline and driving operational improvements. Private equity professionalises, for the benefit of both the company and in delivering a return for the investors. Private equity is about partnering with the management team."

Add the art of the possible to the list. "In one particular business we went on to invest in, one of the owners was the chief executive, the other, a non-exec, wanted to retire," recalls Menton. "Between them they wanted to sell 80%, with the CEO maintaining 20%, which meant he would be both a seller and a buyer in the transaction. We've helped him to internationalise what was predominantly a UK business, helping to focus the strategy and leveraging our network, as well as assisting him make an important acquisition. In two and a bit years the business has more than doubled its turnover.

"We see ourselves as growth capital investors providing a much-needed injection of capital and often allowing the entrepreneur to de-risk by crystallising some value at the same time. There's absolutely no question of investing if the management team doesn't support it, because we're not in the business of running the companies we invest in.

"During the years before 2008, much of private equity edged up in terms of fund size to focus on mid and top-tier companies. I believe this has left a real equity funding gap for those like us who are prepared to invest as little as £5million into a business.

"Historically there were numerous sources for funding, so where in our view is the added value in private equity? Firstly, there are far fewer sources available now than ever before for those seeking capital for growing their businesses. In addition, the focus and discipline private equity encourages allows high growth businesses to deliver the desired outcomes in line with the plans which have been pre-agreed. Often a business with an ambitious management team will have too many projects on the go to develop properly, so there is a lack of focus. We try to help them consider the macro picture. With private equity investment there is less likelihood of a company being distracted.

> "Companies which have been in the same ownership for a long time can often be reluctant to invest. We're looking at investment to improve the growth profile rather than produce a short-term dividend; it's about building a business."

And Menton doesn't believe that most directors are actually unaware of that. "I have to tell you, Britain is probably the most sophisticated private equity market in the world, so I'm not sure that the majority of companies which could benefit from investment are closed off to the idea," he says. "What we are looking for are companies with a £1.5million to £4million operating profit. Only a small percentage of companies in the UK make in excess of the £4million, but a large number make up to £4million, so we have a really attractive landscape."

Why leverage is a benefit

But Charlie Johnstone, director at ECI Partners, thinks that better perception building is a prerequisite for private equity. "There's a lot of confusion as to what private equity actually is," he maintains. "The Phoenix Four at Rover weren't private equity investors, which is how they were portrayed in the media, but four private individuals. I do feel that private equity was too circumspect when it was under pressure from the media and unions as a reaction to some of the bigger deals which made the headlines. That gave the impression that private equity had something to hide. In fact, private equity thought that if it communicated openly with its own stakeholders, that would be enough - however, that was naive, because it allowed a vacuum in terms of understanding to be created.

"I could say it was even more fundamental than that. Not every company is appropriate for private equity investment. Sectors with volatile swings in markets shouldn't have much leverage otherwise they can be put under strain very quickly. Look at the oil services sector where private equity multiples could be nine or ten times, with leverage making up half of that. But this is a sector which is hugely exposed to the oil price, which is extremely volatile even though the trend is upwards. Am I saying that it shouldn't attract private equity investment? No. But it needs to be appropriately leveraged to withstand those swings."

Indeed Johnstone argues that leverage is a benefit. "It is one of the things we find that focuses the directors on cash and how it needs to be used better in areas of the business where it generates the best return," he says.

"The most simple benefit of private equity is the 'goal congruence' of management and other shareholders in terms of the capital value of the business. There's nearly always some change in share ownership when private equity becomes involved, and always an increase in the number of executives who gain a shareholding because they're the people who will drive the growth in value of the business.

"One of the understated attributes of private equity is the contacts and experience we can provide - which is additional firepower for companies. We've invested in 250 companies in the last thirty years; we've seen all the scenarios of crises and opportunities which companies will face. That means we can really help them at their flex points and give them confidence in the tough times.

"We were six years in with Holiday Autos when in 2001 we were thinking of crystalising our investment. Then September 11th hit. We had the experience to help adjust the company's strategy in a time of crisis to give it resilience. Six months later we were back on track and two years on the company was successfully sold. We provided the calmness to identify the way forward while other companies without that input were thrashing about or surrendering.

"One of our companies is a small firm which exports technology. After winning a contract from Iran, there was a last minute hold-up from Customs and Excise. The directors had no experience whatsoever of what to do next, but another of our businesses knew an external consultant who was an expert in dealing with that sort of problem. He not only helped them get that licence they needed but he also reviewed their processes so they wouldn't have the same problem again.

"We're not in the business of running the companies we invest in but we do have involvement in agenda setting. Business angels, by way of comparison, I think find it difficult to make the distinction between mentoring and advising and being hands on."

And Johnstone is adamant there is investment wanting a home. "Look at global capital," he says. "Despite the economic situation there are still huge amounts seeking returns. And take this country specifically, seen as a safe haven, with a trusted legal system, a place where private equity has a good track record on returns. The best way of demonstrating all of this is the number of people putting capital into private equity, and it's not because they want to lose it! There is still an excess of capital to opportunity.

"There is a big difference in availability below £10million of investment and above £10million. Private equity will say it's better to have bigger funds under management, and the mid-market has moved up. But what we are seeing is innovation in private equity, with people leaving existing houses and starting smaller funds.

"My biggest concern is that companies needing less than £10million and struggling to get it will find it harder to develop, which will be a real issue for the country's economy. While the top 100 companies pay 75% of corporation tax, SMEs represent 50% of the workforce.

"If I look at the companies we back, most were funded by themselves and by their customers who paid at the right time because they valued what they were receiving. If a company can get its customers to do that, it means it has something which could be of real growth potential. But the banks have looked at what are the most profitable areas for them, and it's above £10million, which is the low-hanging fruit they are going after.

"Are we putting more equity into deals now? The answer is yes, and there is a better understanding in the industry about the balance of leverage, equity, and risk."

And a better understanding of timelines perhaps when it comes to private equity involvement? Johnston doesn't miss a beat. "There are two benefits of having an exit timeframe in mind," he says. "If, after four to five years we haven't shaped a business which cannot grow after our involvement, then nobody will buy it, so if a private equity is going to asset strip, it isn't going to achieve that. The four to five-year investment focuses the mind on delivering projects more quickly than would otherwise happen without the timeframe. And without that timeframe, they might not happen because the directors feel they are doing well enough."

But 'exit' sooner rather than later can still be difficult to grasp for the entrepreneur who didn't start up in business with the intention getting out of it, and who sees it as an intrinsic part of their life. "There's that old joke," quips Peter Hodson of NVM Private Equity. "When someone arrives at a party, how do you know they're in private equity? Because they walk into a room backwards eyes fixed on the exit."

Intentions challenged but in a good way

"Exit is a four letter word in more than one sense for some entrepreneurs." muses Bobby Hashemi, partner at Risk Capital Partners. "Initially they talk about it with as much enthusiasm as having a conversation about death, so we have done several successful development capital deals taking minority stakes in order to partner the founders through their growth journey.

"The problem is that hedge funds and private equity are given the same broad brush treatment; they're all the same, a bunch of financial engineers making money out of an entrepreneur for doing nothing. We aren't financial engineers at all. We create value from the growth of a business.

"But we don't breeze up to a meeting once every couple of months, ask a few questions, and go home. We have a personal stake in the business; just as the entrepreneur. So we challenge intentions but in a good way, because we share a vision for the company and to achieve it we all have to be pulling in the same direction.

"The business has to grow and benefit from the operational value we bring. Private equity buys earnings potential.There is a movement towards private equity because the banks are reticent about extending leverage. But we don't make our money just from leverage. Of the £75million Risk Capital Partners has invested, £25million is our cash.

"We're not typical private equity investors. We've started businesses ourselves and now we've crossed the fence. Our chairman is Luke Johnson, who grew Pizza Express, then started Signature Restaurants, which went on to own The Ivy and Le Caprice, the Belgo chain, and the Strada restaurants. When I started Coffee Republic in 1995, my goal was keeping control, and one of the ways of maintaining that was not involving professional investors. I brought in £600,000 from business angels after using the government's loan guarantee scheme to open the first shop.

"I think what we bring to the table is our unique position as people who have not only made successful businesses but also mistakes on the way. And I know that my business would have multiplied if I had had a Risk Capital Partners alongside me.

"This is where private equity can add value. It doesn't end with the deal; it's on-going. We can spot a weaknesses in a business as it moves forward because we are involved but from the outside. I think for entrepreneurs this is less about giving up some equity and more about control. If I had left a high-powered job to start my own business, of course I want to be in control.

"The entrepreneur is a loner, and private equity fills the gap by being a mentor, a real mentor because their money is involved. A rigorous conversation about possible investment in itself invigorates a company by getting the directors thinking. Private equity wakes a company up, lifts their game - there's the discipline of the accounts being prepared at the right time, of having board meetings to talk about strategy.

"Making an acquisition can be a huge stretch for the management team of a fast-track growth company. Between 2006 and 2010 one of our companies was able to make several acquisitions because we were able to help with the due diligence and the other time-consuming disciplines of doing a deal."Interestingly, money is not the only motivator for the owner-manager to sell to private equity. I've seen a number of businesses where the founders live in the same community, where they has a lot of hires. A trade sales makes them £10million but they're dead embarrassed when three months later everyone has lost their job because the buyer relocates the business."

Seen as business coming of age

"There's still a misconception that private equity has to take a majority stake," confirms Jonathan Gregory, partner at Matrix Private Equity Partners. "We're a minority investor; we own 16% of a garlic business for example, and we are very happy with our investment. It's interesting that in the USA, there is almost status in having an equity investor; it's seen as a business coming of age.

"The big private equity houses buy a business and then cut the management team in or make the acquisition and then worry about who they should bring in to manage it. A smaller private equity house will back the management team to buy or develop the business.

"When the banks were giving away money and had no interest in having a board member, I'd imagine private equity looked unattractive. Talk to your accountant and they'd say with the bank you don't lose any equity, all you do is pay interest. Now we're writing cheques ourselves to get the deals done. We don't need to re-finance them, so it's sustainable in a low interest rate environment. The process of getting money from banks is more of a nightmare; they'll make the decision right at the end, when costs have already been incurred. Before, banks were the default position, and the market looked to private equity to fill any gap. Above £10million the banks are playing, but otherwise there has been a big seed change.

"If companies with potential have restricted access to capital, the likelihood is that they will grow less quickly, but the recession and economic uncertainty has made companies think more carefully about how they manage their capital. In that respect they should be better run businesses.

"I think private equity makes management think much more about strategy, the journey, rather than just the day-to-day. A private equity backed company has to do that to deliver shareholder value, and the entrepreneur doesn't. As an external shareholder we need to see the business develop from where it is now to a position where someone will want to buy it.

"Private equity does require corporate governance - we want the FD and the ops director to make a proper contribution rather than the MD telling everyone what they should be doing; we want to hear what they have to say. We encourage the appointment of a chairman who won't necessarily have relevant sector expertise but is an experienced chairman who will ask the obvious but often ignored questions and will encourage challenging, open discussion. That results in people thinking about decisions which historically might have been taken by rote, to consider why something has being done a particular way before. Maybe the answer is that it's the best way, but at least it's been considered.

"And often, the owner-manager can get bogged down in relationships. I've learnt that when an MD says Joe isn't working out, my reaction has to be to say 'deal with it or it will fester and get worse'.

"Entrepreneurs think they know best - what could a private equity house possibly tell them about their business that they don't already know. And do you know what, the truth is, not very much. But we'll get them thinking in a different way. We don't run their business but we're guides; we can see what isn't quite right because of our helicopter view."

Cost cutting? Really it's about growth

"Directors see us bringing the experience that they may not have to the table," argues Christian Brunning, partner at Gresham Private Equity. "We can help them develop their strategy because fundamentally, the most important thing is that we are very much a partner, and it's a relationship of trust. We can bring together the CEOs of all the businesses in our portfolio to compare notes and learn from each other. We have a training business which brought us on board to help them develop overseas, and we already had other companies we'd invested in with offices internationally, so that was able to assist them.

"We also saved another company £250,000 a year on their mobile phone bill by putting them in touch with another business we had invested in. But there's a relatively broad misconception, usually with those that haven't come into contact with private equity, that we are all about cost cutting when really it's about growth."Part of the reason that many businesses get us involved is that even though they have real potential and opportunities to pursue, they are slightly nervous of taking the next step, and are risk adverse. We can bring in a team to help them assess the risks better. Hotter Shoes for example, was a company owned by two brothers - one wanted to grow the business, but recognised that he didn't have the skills. We introduced a management team, helped change them from what was essentially a catalogue business into an online one, with branches, and also did a test mailing to the US. We talked them through it all and assessed the risks for them, and the growth of their business has massively increased since we got involved.

"Two of the companies that we've bought have been spin-outs from large corporates, and it has made sense to do the deals on an equity basis from day one, and then bring a banking partner on board when things have settled down a bit. It helps to raise confidence in a deal if we're prepared to do it on equity in the first place.

"Most of the deals we've done in the last year have been off-market, which means we've been able to spend longer with the management team and the business – more than we would have done in the environment we had before. Also, business plans are more cautious now, so there's less gearing put in.

"We welcome businesses coming to us for a chat – there's no wasted meetings as far as we're concerned – and there will always be business opportunities for them through our network. The due diligence can be very useful for the management of a business. Some people think that due diligence is about finding issues, but off-market, it's more about us understanding them and what other opportunities there might be. It should be a confirmatory process.

"A number of businesses coming to us now might have gone to the banks in the past, but now they are looking for other routes to find capital. There's much more opportunity in the mid market. For us, we're looking for good management teams wanting to double or treble their profit. Most of them have international aspirations.

"In the past, the average term has been three years to exit, but that is usually driven by the management teams rather than us. It's harder for us to find a new deal than to keep growing a business, so in some cases we'd rather sit a bit longer – as long as we can still see that there's potential. We try to ensure that we have a similar mind set with management with regard to exit at the start though.

"If businesses aren't growing now, will there be less opportunity in three to five years time? I don't think so, because we are focusing on investing a bit earlier if we can see the potential; when they are smaller which can be the right time to pick them up and grow them. There's also the continued fall out of subsidiaries from groups will continue to send businesses our way."

When something needs to happen

But there could be a reason why the owner-manager might look at private equity in a different light.

Explains Shani Zindel, partner at ISIS Equity Partners: "I think we are seeing more people coming to talk to private equity because they've reached a point where they realise they're working too hard, they've come to hate the day-to-day operation, but have everything tied up in the business which they don't want to put at risk. They've reached a point where something needs to happen to bring about change.

"There will always be people who are going to be completely resistant to outside investors, but they are also likely to be the ones who are reluctant to engage with advisers. There are others who don't really want to take their business forward; they don't see the need to bring in new people. On the other hand, there are entrepreneurs who see it as the ultimate validation that private equity has wanted to invest in their business.

"We invest for growth and provide a neater, cleaner path for faster growth than a company could tread left to their own devices.

"Private equity brings focus, and there is a crispness to a company's decision-making because of that. Entrepreneurs tend to be creative and want to try different things, often at the same time. A private equity house would say, let's look at those ten ideas and identify which will add the most value to the business with the least risk. That gives you a greater chance of success, and then we move on to the next one.

"Private equity is very good at building management teams so not everything is dependent on one or two individuals. An entrepreneur can have the control, and will make the decision, but they'll need good people around them for the execution. The finance director also becomes a real driver of value because they will be producing data on business performance.

"Because a private equity house sees so many businesses, they understand the building blocks, what it is that a company really needs to grow, and the potential breaking points, such as the need to significantly upgrade IT. But I would make the point that a private equity house works with the company's existing culture. We will talk about the need for professionalism in processes and procedures, but we don't tamper with the culture. Wiggle, the online bike shop, has grown tenfold since we invested but it's still a cool, trendy brand and its values haven't changed.

"No matter how the deal is structured, and we can take less equity with a loan note structure which solves the problem of the entrepreneur not wanting to give up too much equity, the bottom line is that our money is at risk. If it doesn't work out, we all lose. If it does, we all win, usually ten times more for management than us, and deservedly so. Private equity can be completely life changing for them. The goal is for everyone to do well out of the investment.

"In the absence of debt, private equity fills the gap. The difficulty is that with low interest rates, possible vendors wonder what to do with the consideration after they sell. They might take the view they may as well keep it in the business because that's where they are getting the best return.

"That said, while owner-manager vendors want to do the best deal for themselves they also want to leave a legacy, and that's tied up in the people in the business. And because private equity provides incentivisation and motivation for management, the business keeps moving in the right direction."

Growing confidence money is available

What could have an impact both on the perception of private equity, and maybe its modus operandi, is the Business Growth Fund, set up with a £2.5billion investment put in by the four major clearing banks and Standard Chartered. This isn't a quango, or funded with public money, but a commercial, independent venture with the shareholder banks uninvolved in the decision-making because of course individually they're in competition with each other.

"We're not here to provide funds which could be put in by existing players," explains regional director Marion Bernard. "We're buying a minority stake, typically between 10% to 40% in established, profitable businesses that have a turnover of £5million and above and which have a need for £2million to £10million. A typical investment would be five to seven years, but it could be ten; we're patient investors. Business Growth Fund would provide three or four non-executive director candidates so the entrepreneur can choose who they would work best with."

"Business Growth Fund isn't interested in management buy-outs or re-financing. It's about enabling a business to scale up its operations, to pursue a buy and build policy, to take exporting or overseas development seriously. Funding is available to take out an existing investor but the majority of the money has to go into growth. Another type of involvement could be loan notes alongside equity, which would probably create a bit more confidence for some more bank lending. Our network of six offices across the country is crucial, I think, because it gets us closer to companies which otherwise might not have thought of outside investment as an option. We believe we can grow the marketplace for investments."

But could this be a case of the supplier creating demand? Bernard isn't concerned one way or the other. "What can be achieved in additional value from growing an existing British company has got to be good for the economy," she asserts. "When companies realise there is capital available, they might begin to compile a shopping list of things they want to do but didn't devote time to before because they didn't have the confidence that they could raise the money. It's a different mind-set from how would I use the money if the investor was funding my exit."

Bernard points out that an equity gap isn't necessarily the same as a demand gap, and there's an element of assumption that £2million to £20million is the sweet spot. That said, relatively speaking there are numerous funds providing up to £2million of investment.

"The value we bring to companies is upping their game, absolutely," she says. "We introduce our specialists in IT, HR, operations not just during the process of considering the investment but in advising on possible improvements which would help the business grow."

"I accept that in a few cases we could be looking at some businesses which are also of interest to private equity, but in those few cases we're at least providing a different option. Most companies though just can't get growth capital elsewhere.

"The bigger barrier could be that in a difficult economy, entrepreneurs are less happy with risk, their ambition is diminished or put on hold by a lack of confidence in economic prospects as well as the difficulty in getting the necessary funding."

What happens in the real world

"I think there is a consistent message that private equity houses genuinely believe their proposition is beneficial for business," observes Steve Brown, head of private equity at RSM Tenon and co-author of this report. "I'm talking about the private equity houses which typically invest in transactions up to £50million in size. This is the real world where capital can make a significant difference to the growth and success of companies, and to the fortunes of their owners and managers, and indeed our economy as a whole.

"But it is clear that this message has been lost somewhat in the last decade or so as an abundance of ultra-cheap deb, until 2008, coupled with somewhat dysfunctional stock exchanges led to the emergence of a new tier of private equity, targeted unashamedly at the acquisition of household names on the world's stock exchanges in highly leveraged deals.

"Arguably this behaviour is an entirely intelligent response to the limitations of the public markets themselves over that period of time, coupled with the availability of plenty of debt. But the public perception it created was of a small band of asset stripping millionaires getting rich at the expense of others. And do you know what, there may well have been a degree of truth in that - distasteful sure, but unlawful no.

"The fact of the matter though is that it made people suspicious of private equity in general - they weren't making the distinction between those doing the big-ticket, financial engineering deals and the traditional mid-market, sensibly structured involvement of private equity to enable a sustainable business deliver improved growth and value for everyone involved.

"Until the financial crisis, directors had also become used to the notion that for any funding requirements they may have had, the banks would oblige; there was certainly plenty of evidence of banks lending to satisfy equity funding requirements on the basis that a business had a good pulse and was profitable and growing. Well, boom and bust had ended hadn't it? Lending larger amounts for longer terms just seemed less risky – and debt was very affordable.

"But now that party is over and banks have necessarily reverted to appropriate behaviour, and the role of private equity to fund growth and shareholder value appreciation in the lower and mid-market is once again moving centre-stage.

"It may take time but private equity in its widest sense, development capital, growth and acquisitions capital through to 'exit' capital, will I am sure return to being a key ingredient in the success of businesses going forward."

Reference:

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