INVESTMENT KNOWLEDGE SERIES

RAISING EQUITY CAPITAL

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INVESTMENT KNOWLEDGE SERIES

Raising Equity Capital - an Introduction

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At various points in the manual a number of financial analysis issues are examined.
The financial analysis implications for these issues, although relatively standard in treatment, remain an opinion of the authors of this manual. No responsibility is assumed for any action taken or inaction as a result of the financial analysis included in the manual.

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Contents

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1 • Introduction

Equity is the bedrock of a company's capital. In its early days, equity is the capital required to start up a business; as the company grows it is the capital that allows it to reduce the risk that comes with rapid growth; and in later years it is the capital that provides flexibility for expansion for the company, and the potential for high returns for investors.

The primary definition of the word 'equity' is 'the quality of being fair and impartial'. In a financial context, however, 'equity' usually refers to the ordinary shares in a company (in the US, these are referred to as 'common stock'). Each share represents a unit of the ownership in a company, paid for by a contribution to the company's capital. The concepts of fairness and impartiality underlie the features of, and rights attaching to, equity capital.

Rights attaching to equity are similar in most developed countries, but are not by any means identical. In this book, any discussion of equity laws and regulations refers to those in the UK.

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Features of Equity

The rights and features of a company's equity are set out in its Articles of Association (its bye-laws). The basic features of ordinary shares are as follows:

Equality of treatment: All of the shares of a particular class must have the same rights. A company may however have more than one class of equity shares, and each class may have different rights. These rights are set out in the company's Articles of Association, which is the company's constitutional document stating the reciprocal rights and obligations of the company, its investors and its shareholders.

Voting rights: Each share normally carries one voting right, which can be exercised to approve or reject company resolutions at general meetings. Shareholders have the right to vote on ordinary resolutions – such matters as the approval of a material transaction or appointment of a director – and special resolutions – such matters as an alteration to the company's Articles of Association or capital structure. Passing an ordinary resolution requires a simple majority of votes cast at the meeting to be in favour; passing a special resolution requires 75% of votes cast at the meeting to be in favour.

Dividend entitlements: A company is under no obligation to pay a dividend to its shareholders, and it is illegal for it to do so if it does not have sufficient distributable reserves (broadly, surplus on its profit and loss reserve). If it does pay a dividend, then the dividend must be shared equally between the shares, with each share carrying an entitlement to the same amount. Although the company's directors decide whether the dividend should be paid, their decision must be approved by the shareholders. Shareholders can approve or reject the payment, or approve a reduced payment – but they cannot demand more than the directors have declared, or demand a dividend when the directors have not declared one.

Distribution rights: If the company is wound up (liquidated), each share carries an entitlement to an equal proportion of any and all proceeds left after the payment of the company's liabilities.

Subordination: Shareholders rank below all other capital providers. This means that they are not entitled to any dividend or repayment of capital until all other capital providers have had their claims met. An equity dividend can only be paid if there are adequate distributable reserves after payment of debt interest, preference dividend and taxation. Moreover, if the company is wound up due to financial distress, then the proceeds must go first to repaying debt providers and other creditors, as far as funds allow; shareholders normally receive nothing.

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Order of repayment of winding up (UK)

Fixed charge lenders (e.g., loans secured by a charge over fixed assets)

Floating charge lenders (e.g., loans secured by current assets)

Preferential creditors (e.g., wages, payment arrears to pension funds)

Unsecured creditors (e.g., trade suppliers, pensioners)

Preference shareholders

Ordinary shareholders

Transfer: In most cases, shares can be transferred (sold) from one holder to another at will. In some cases, the company's Articles may impose restrictions, so that (for example) shares can only be sold to persons approved by the company's directors or to other shareholders of the company, or only to nationals of the country where the company is incorporated.

Nominal value (par value): Shares usually have a 'nominal' value which represents, firstly, the value that was originally paid for the very first shares the company issued; and secondly the absolute minimum that can be paid for any new shares of this class to be issued in the future. This is typically a very low value – say 1p, 10p or 100p – and bears no relationship whatsoever to the company's asset value, earnings or quoted share price. In some countries it is possible to have nil par value shares; this is illegal at present in the UK.

Irredeemable: With the exception of some investment entities, ordinary shares are the permanent capital of the company and can only be redeemed in specific circumstances, generally with court approval. Shareholders who wish to realize their investment must sell their shares, either by private contract or on an exchange.

Additional Features of Equity

Some companies may have additional rights or restrictions attached to their ordinary shares. In some cases these are due to regional custom and law, and in others they are a means of protecting the interests of the original founders of the company, or of new investors.

Differential classes: The great majority of companies have one single class of ordinary shares. However, in companies with private equity backing, or where there has been fundamental re-organisation in the past, the ordinary shares may be divided into different classes. Both are classed as equity, but the two classes may have different rights in relation to dividends, voting and distributions.

Pre-emption rights: These provide that, where a company wishes to issue new shares to raise cash, these shares must be offered to its existing shareholders, in proportion to their existing shareholdings, before they can be offered to new, incoming shareholders. The purpose of these pre-emption rights is to protect the interests of existing shareholders, by giving them the right to avoid dilution of their voting rights through participation in any new equity fund-raising. Pre-emption rights are enshrined in company law across the EU and in a number of other countries; but they are not required for US-incorporated companies.

Shareholder defence mechanisms (poison pills): These are arrangements designed to protect the company from a hostile takeover. With most poison pills, any takeover threat triggers a change to the number of shares in issue or the rights attaching to shares, to weaken the position of a hostile bidder.

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Example

In September 2013, US grocery store operator Safeway experienced unidentified stake-building in its shares, driving the price up 10% in one day. It reacted by announcing the adoption of a one-year stockholder rights plan, giving each shareholder one preferred share per ordinary share held. In the event that an activist shareholder acquires a stake of over 10%, or if a passive investor acquires a stake of over 15%, preferred holders have the right to acquire ordinary shares at an exercise price of half the market price. If triggered, this would dilute the holdings of the stake-builders, who would not be eligible to receive these rights.

Different Types of Equity

Founder shares: these are shares that are issued to the original founders of a business. Not every start¬up company will create a class of 'founder shares' but where they are created, they are created alongside another class of shares with different rights. For example, a venture capital firm might back a start-up company; it would invest in a class of equity shares giving it priority in dividends and additional voting rights. However the founder's shares, with no dividend rights, might carry an entitlement to a far larger proportion of the residual value on exit.

Deferred shares: These are shares where all the rights are deferred until some later date or event, when the shares are said to 'vest'. They are frequently used as an incentive tool for management, so that the right to votes and dividends are deferred until the holders have worked with the company for (say) five years, or until their performance targets have been met.

Golden shares: Where a company has been privatized, usually through listing on a stock exchange, its state ex-owners may retain a 'golden share'. This might carry the right to block a takeover or to receive an enhanced dividend, or some other right.

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Example

2001 saw the privatization of QinetiQ, a division of the UK state-owned Defence Evaluation and Research Agency. QinetiQ makes bomb disposal robots and snipe detection systems, and in the interests of national security the UK Government retained a single 'Special Share', giving it the power to impose restrictions on company activities and overseas contracts. However, in 2012 these restrictions were relaxed, although the Ministry of Defence can still prevent a person acquiring a 3% holding, on grounds of national security, or a 10% holding, on the grounds of conflict of interest.

Hybrids: This class is comprised mainly of preference shares (also called preferred shares), which carry some characteristics of equity, and some of debt. Preference shares can be perpetual, redeemable at face value or convertible into ordinary shares at a set date. They may carry a set dividend (expressed as a percentage of face value, or based on a formula), or a 'participating dividend' which gives holders a specified share of the company's profits. This dividend ranks ahead of the ordinary dividend, so that no ordinary dividend can be paid until the preference dividend, and any arrears, have been paid. In a 'cumulative' preference share, any dividend that is not paid in a particular year (due to inadequate reserves) must be paid once reserves allow; if it is not cumulative, no arrears are paid. Finally, preference shares do not usually carry any voting rights.

Example

National Australia Bank has in issue convertible preference shares listed on the Australian Stock Exchange, issued at their face value of $100. These pay a discretionary, quarterly, floating rate, non-cumulative dividend equal to the sum of the bank bill rate plus a 3.20% margin. The preference shares mandatorily convert into NAB Ordinary Shares on 22 March 2021 provided certain conditions are met, or earlier if required to by prudential regulatory requirements.

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Corporate Funding Options: an Overview

All companies must have owners, and so they must have equity funding in their capital mix, even if it is just a notional amount. However, corporate growth must be funded by additional capital, to purchase tangible assets, make acquisitions and provide working capital. This could come from debt finance – if the company has adequate cash flows to service the debt, and if market conditions permit.

Debt finance has the advantage of being relatively cheap, particularly as the interest is deductible for tax purposes; and it does not dilute the voting power or distribution rights of the shareholders. Moreover, it leverages up the potential growth of the company: providing external capital to generate growth in shareholder returns.

It has the drawback, however, of creating additional risk for shareholders, as debt providers have a prior claim on the company's operating cash flows, so that interest must be paid before tax and before dividends. Bank lenders impose stringent financial, non-financial and information covenants on borrowers which can be quite restrictive for smaller or under-performing companies.

The availability of bank debt is also limited in practice by standard loan capacity metrics such as Net Debt:EBITDA and interest coverage ratios, so that companies that already have high levels of borrowings, or with low or no earnings, must look to equity for their growth capital.

The main sources of equity finance for companies are:

- **Founders, friends and families**: early stage and seed finance for start-up companies, sometimes referred to as the 'three Fs' (and also sometimes referred to as 'founders, fools and families', as the failure rate of start-ups is so high). At the earliest stage of a company's life, this is usually the only source of finance that it has available to it.
- **Venture capital**: alongside the 'three Fs', or supplementing this, venture capital is equity or quasi-equity finance provided by third party investors, who may be private individuals ('business angels'), venture capital funds, or corporate investment arms. This may be available as short or medium-term finance for early stage or start up companies.
- **Private equity**: equity and quasi-equity finance, again provided by third party investors for a limited term, generally through pooled private equity funds, and generally available for established businesses to provide expansion, development, acquisition or buy-out finance.
- **Public equity**: equity finance provided by the wider investing community, accessed through an initial public offering on the equity capital markets, and later through secondary share offerings.

In the following chapters we will look at how companies can access venture capital, private equity and public equity, and look at some practical criteria and constraints.

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2 • Private Equity

Overview of Private Equity

Private equity is finance provided to unquoted private companies in exchange for equity (and other) capital in that company. It can be provided at a number of stages in a company's life cycle:

- **Start-up, early stage** businesses: at this stage it is referred to as venture capital, and is discussed in more detail in the next chapter.
- **Development capital.** This is capital provided to established, cash generative companies to help them move to the next stage of their development.
- **Expansion capital.** Again, capital provided to established, cash generative companies, to help them grow in terms of scale or scope; perhaps by allowing them to develop new products, increase production facilities or expand into new markets.
- **Acquisition finance.** This is capital provided to a company to help finance an acquisition of one or more other enterprises.
- **Management buy-outs or buy-ins.** Capital provided to a management team, to enable them to buy a business. In the case of a management buy-out (MBO), this capital is provided to incumbent management. In the case of a management buy-in (MBI), this is provided to in¬coming management. Where incumbent management co-operate with incoming management, this is referred to as a buy-in management buy-out, or BIMBO.
- **Secondary buy-outs.** This is capital to buy out the interest of an incumbent venture capital or private equity investor; one investor replaces the other by acquiring its equity interest.
- **Rescue/recovery finance.** This is capital provided to a company in financial difficulty, to enable it to survive, restructure and recover.

The common theme in each of these stages is that the finance is provided when:

1. the company needs finance to achieve a change. This could be expansion, change of control or survival; and

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2. for one reason or another, the company's financing needs cannot be met in full through the mainstream sources of bank finance or the equity capital markets; i.e., the company has a funding gap.

The Goals of Private Equity

At its simplest, the private equity process can be summarized as:

Find ▶ Buy ▶ Change ▶ Sell

1. **Find**: The private equity firm identifies investment opportunities meeting its specific investment criteria, that have the potential for high returns.
2. **Buy**: The firm makes an equity investment in the business concerned, ensuring that it secures a reasonable degree of control.
3. **Change**: During the investment period, the firm expects to see an uplift in the equity value of the investment, through changes to management, strategy, structure or financing.
4. **Sell**: The firm plans to exit each investment within a time period of, say, three to five years, by way of an IPO or trade sale.

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At the end of the investment period, the private equity firm hopes to have seen a profit on its investment, through a combination of dividends, interest, fees and capital gain. This can be expressed as either:

- An internal rate of return (IRR; that is, an average annual compound return on investment) appropriate for the risk of its investment. This return should be well in excess of the return it could have achieved in the public equity markets; a rough rule of thumb suggests that many firms are looking for an IRR of 30% on their portfolios.
- A money multiple/cash multiple. This is a simpler calculation, reflecting just the proceeds on exit together with any dividends or interest received, as a multiple of the total investment.

Example

In September 2006, Graphite Capital acquired NES Global Talent, a recruitment business, in a £70 million management buy-out. Over the next six years, the investors and management internationalized the business; EBITDA increased six-fold, and its overseas markets more than doubled. In November 2013, Graphite sold the company for £234 million.

Private Equity Firms

So, who are the private equity firms? With the exception of certain forms of venture capital, private equity finance is provided by professional investment entities, but these vary considerably in terms of their size, investment approach, risk appetite and modus operandi. In this chapter, we will look first at the most typical features of private equity firms, and then touch on some alternative structures.

Private Equity Funds

The majority of private equity (by value) is invested through private equity funds. These are collective investment schemes, where finance is contributed by a number of investors, pooled in a fund, and then invested by the fund manager (in this case, the private equity firm).

The majority of funds are structured as limited partnerships rather than as incorporated companies, with the investors and the private equity firm all being partners.

The private equity firm takes the role of general partner (GP) in the fund. As GP, the firm generally invests its own capital in the fund, alongside the external investors who are limited partners (LPs) in the fund.

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General Partners and Limited Partners

The **limited partners** are the underlying external investors in the funds. They are typically a mixture of high net worth individuals (HNWIs) and investing institutions, which include pension funds, insurance companies, family offices, endowments, charities and sovereign wealth funds. LPs take a 'hands-off' role in the management of the fund and identification of investments. Their liability for the obligations and debts of the fund is limited to the amount of capital they have invested; i.e., they cannot lose more than they have invested.

The general partner is the hands-on investor, and is usually the sponsor and the manager of the fund. The GP's liability for the obligations and debts of the fund is unlimited. The GP is responsible for:

- Fund raising: identifying potential investors and marketing the fund to them, promoting the fund on the basis of the past performance of the GP's prior funds as well as current investment focus; the fund must have sufficient critical mass to achieve its investment aims.
- Identifying and analyzing potential investments: ensuring that the fund invests only in those investments with the potential to generate a significant return for the

private equity firm, and carrying out research into their products, potential markets, management teams and rivals.

- Negotiating and structuring investments: ensuring that the fund's individual investments are protected as far as possible, through negotiation of shareholder/investor agreements, board representation and differential share structures.
- Monitoring investments: in private equity, the investor expects to have a very active engagement with its portfolio companies, including appointing a representative director to the board, reviewing budgets, forecasts and management accounts, leading discussions with banks and other investors, and influencing strategy.
- Arranging follow-on capital: for earlier-stage businesses, finance is generally provided on a 'stage-by-stage' basis, with each stage of investment being negotiated separately. If the company doesn't meet its stage one targets, or comply with its obligations under the investor agreement, stage two capital may not be available.
- Arranging the exit: in due course, exiting each investment in order to generate a return for the fund's investors.
- Managing the fund: ensuring that the day-to-day administration of the fund is properly carried out, that LP funds are drawn down in time for investments to be made, and that returns are properly paid out to the LPs.

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Limited Partnership Structures

Limited liability partnerships are widely used in private equity and venture capital funding, because they provide a tax-efficient, lightly regulated, internationally convenient investment structure. The partnership is **tax transparent**; that is, the profits generated by the fund in the form of dividends, interest or capital gains are not subject to corporation or other tax; instead they are distributed gross to the LPs. LPs are of course responsible for paying any tax due in respect of their individual profits and dividends.

Most funds are structured as **closed end funds**: that is, they are established in order to raise a particular sum of money, and once this has been raised the fund is closed. LPs' interests cannot be redeemed, and no further investors can be admitted, during the term of the fund.

Raising Equity Capital complements Capital's Investment Knowledge Series by providing a concise guide to the rationale and practicalities of raising equity finance for companies. This manual starts with first principles of corporate funding, and takes the reader through the processes and considerations of raising venture capital and private equity, as well as primary and secondary equity capital market offerings.

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