FINANCE

Private Equity – Smart Financial Source for Expansion

Corporate development and strategic moves require significant investment. The time and pace at which this happens may not be the choice of the company but could well be imposed by market conditions. What if this means a radical reorientation at a moment the company's resources are limited?

Opportunity Knocks

Innovative companies are more likely to be exposed to such situations than those who operate in more predictable, traditional market sectors. Technological companies are particularly challenged by continuous technological change, increasing complexity and shorter product life cycles. Companies that are prepared to make best use of their competencies treat these shifts and changes as opportunities. Their objective is to build and maintain a strong strategic position through differentiation and leadership.

Lack of Financial Strength – a Spoilsport

A strategic expansion, an out of the common product development or a venture on new markets call for exceptional funds that are in most cases a bottleneck. Supposing that previous profits had been regularly reinvested, it should be assumed that the current shareholders will not be in a position to provide substantial extra capital. Bank loans are not the answer either. Commercial banks are increasingly cautious to take entrepreneurial risks and even if they did, the company would (1) consume most or all of its borrowing capacity and (2) become highly dependent on banks. Indeed, should the company not reach its goals, it will certainly suffer financial stress which may degenerate into a corporate crisis. Especially when engaging into new ventures, the company should be prepared to face the unexpected and should have sufficient resources at its disposal.

Private Equity Partners

Shareholders of expanding companies are facing the alternative of scrapping or adapting their ambitions or finding themselves suitable partners, willing to invest capital for expansion. The suggested solution is Private Equity, risk capital for privately owned (not listed) companies which have so far been successful, gained a leading position on the market which can be further improved by suitable strategic actions. Private equity is capital that originates from a financial partner such as Investor companies managing a fund, institutions managing their own capital, venture capital. The equity they invest ensures that the balance sheet is endowed with liquidity for the project(s) which are supposed to leverage the value of the company.

Healthy Financial Structure

Private Equity does not exclude debt financing, on the contrary. Thanks to a stronger balance sheet the company obtains a better credit rating thus improving its ability to take a loan without incurring extra risk. As equity carries the highest risk it also imposes a high premium, which is the basis for the company valuation and the share of the stock an investor expects to acquire for a given investment. Therefore it is reasonable to balance equity with debt in order to obtain an optimal ratio. The debt can be a mix of shareholder's loan and bank credit.

A harmonious financial structure is the backbone for the intended corporate development. It also provides the company with a new competitive advantage against existing and future rivals (Cash is King).

Selection of the Partner

Various criteria are important when it comes to choosing a partner (see table below).

Private Equity Partners have an individual investment policy, e.g. minority versus majority stake, mix of investment (equity/loan), selection of the market sector and geographic location of the company. All private equity investors require a credible plan regarding the employment of the invested funds. They need to be assured that the investment is allocated in a way that is likely to create a maximum leverage to the company's business thus creating a substantial increase of

What the Owner Should Expect from the Investor	The Issues of the Investors
• Understands the Company and the market • Fair valuation and fair contract • Entrepreneurial attitude • Active co-operation after the deal • Useful connections (network)	• What is the development stage, (start-up, early stage, growth, consolidations, etc.)? • The strategic potential (growth potential, competitive position). Is the company in a growing or a declining market segment? • Is the organization fit for the tasks (management, infrastructure, network)? • Investment volume • Exit scenario (Going Public, trade sale)

the share value. The private equity investor will evaluate his exit options in detail. Normally an investor will expect to realize his capital gain after 4–6 years.

Smart Money

It is incorrect to assume that all investors prefer safe or problem-free investments. Thanks to their advisory services and their knowledge of the market sector they are able to assess risks and opportunities accurately. Private equity is so-called smart money because these investors bring more to the table than just money. They have extensive experience from numerous investments and will adopt an active role in supporting the company they invest in. By this they provide a mix of benefits: finance, know-how, business connections that open doors. Precisely in this respect will the financial partner be able to enhance the company's chances of success. In practice this support occurs through regular contacts with the management and through their representation on the board of directors. A private equity investor should be a trustworthy partner who will, in the normal course of events, restrain from adopting an executive role. Whilst he will maintain a high profile on the board of directors, he will make sure that the entrepreneurs and their managers lead the business in autonomy.

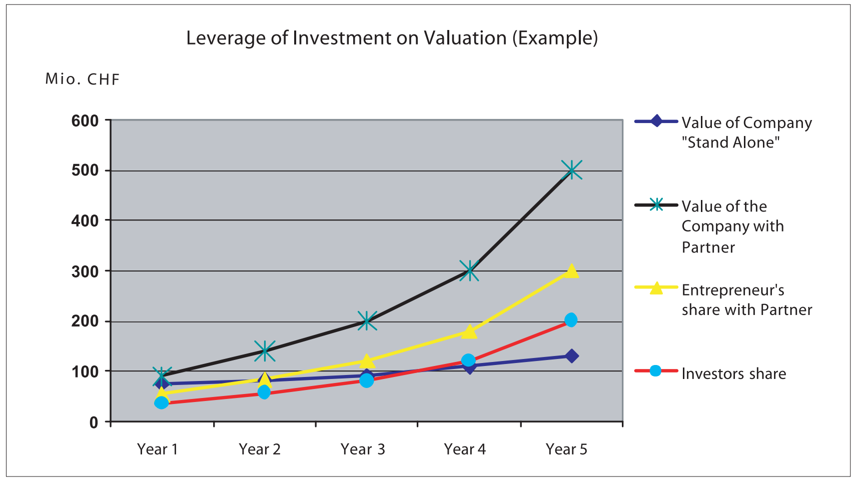
The Exit for Investors

Ideally the entrepreneurs and the private equity partner will achieve a beneficial cooperation over several years. After a successful expansion the company's strategic posture should have dramatically improved. The capital and the know-how of the investor have helped the entrepreneurs to achieve a significant capital gain. The value of the shares they are holding should normally be higher than if they had kept 100% in the first place (see graph "Leverage of Investment on Valuation").

This is the time when the private equity investor and the entrepreneurs jointly introduce the next stage.

The next possible Stage: The IPO or the Trade Sale

There are several options to choose from when it comes to the next stage but obviously only one is the best for the shareholders and the company. The introduction on the stock market (Initial Public Offering – IPO) can be the next sensible or even necessary move for the company. However, even if the market would welcome the company, the pros and cons of a going public should be carefully evaluated. In fact, only about 10% of the Private Equity investments lead to an IPO, which does not mean that the partnership of 90% investment failed. The more likely alternative is a trade sale to a suitable strategic buyer such as a larger competitor. In this case the financial partner and the entrepreneurs sell their shares and hopefully realize a significant capital gain. More scenarios are a Management buy-out or Management buy-in or a merger with a variety of financial solutions for the original shareholders.



How to find the right Equity Partner

There are literally thousands of investment companies with substantial funds. The issue is to find the right match. The deal between the company and the investor is developed in short, logical steps:

- Owners and investors meet for a first discussion
- Investors and owners establish their mutual positions and ask relevant questions
- The investor submits a letter of intent
- The investors inspect the company in great detail (due diligence)
- Signing of the investment contract
- Investment and co-operation over several years

Support in Finding the Financial Partner

It is worthwhile to seek advice from professionals for the search and the selection of the suitable financial partner. They will help you identify the best partners, assist you in setting up the investment memorandum and stand by you when it comes to negotiations. The decision to approach the investor directly of by professional advisers has to be taken early in order not to compromise the basis for negotiations.

The financial advisers enhance the prospects of success. Rather than approaching investors one by one they will be able to contact all the suitable investors at once (broadcast), wherever they are and without disclosing the name of the company in the first place. With their investment banking competence they should accelerate the selection and negotiation process. They know the investment sector and the bargaining issues very well and will spot the differences between a fair and a poor contract. Last but not least, they will relieve the entrepreneurs from the tedious work and the sometimes frustrating experience of dealing with refusals, repeated questions all of which are part of the tribulations leading to success. ■

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