Boca Comm

GLOBAL BUSINESS SERVICES

Boca Comm Global Capital Markets Ltd.

INVESTMENT BANKERS

Private Equity Finance Backgrounder

Private Equity Overview

The generic term 'private equity' encapsulates a variety of sub-investment categories. Here we describe the four different fund types that fall under the private equity banner.

Because of size or lack of infrastructure, many client companies of Boca Comm are deterred from even thinking about raising capital through an initial public offering (IPO).

Many foresighted companies have instead begun to look for alternative financing. In today's interest-rate environment some are seeking bank loans as their best option to secure long-term growth or liquidity funds. However, more and more companies are turning to a relatively new and growing financing option: the private equity market.

More money is flowing into these funds as financial institutions and individuals look for new and creative ways to invest their stock market or other investment gains. Over the last three years alone, the size of the global private equity market has more than tripled, reaching several hundred billion dollars. Despite its enormous growth, small– and medium-size companies have so far paid very little attention to this market, primarily because they lack information about it. The transactions are exempt from regulatory registration (such as SEC registration in the USA) since they don't involve public offerings. Indeed, it is the very privacy of the market that makes these vehicles an attractive option for companies seeking to preserve confidentiality and keep a low profile.

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PRIVATE EQUITY FINANCE BACKGROUNDER

The phrase "private equity" only became widespread in the late 1980s following public interest in leveraged buyout ("LBO") fund activity, particularly in the USA.

Alternative Investments

Private equity is often categorized under the umbrella of "alternative investments", comprising a variety of investment techniques, strategies and asset classes that are complimentary to the stock and bond portfolios traditionally used by investors.

Building Business

Venture Capital is often described as the "business of building businesses", investing in companies that have undeveloped or developing products or revenue. Venture capital has a particular emphasis on entrepreneurial undertakings and less mature businesses.

The private equity market consists primarily of pools of funds from institutional investors, such as public or corporate pension funds, foundations, bank holding companies or insurance companies, as well as from wealthy individuals and families. Those pools of funds are created by a group of professionals called 'intermediaries,' who manage the funds on behalf of investors and then structure the terms of the financing transactions. If you are involved in a private equity transaction, you most likely will deal only with the intermediary, and never meet the underlying investors. Eighty per cent of today's intermediaries are limited partnerships, with the intermediary firm serving as the general partner and the investors as limited partners. Boca Comm functions as intermediaries for its clients seeking corporate finance.

Venture capital funds were, until recently, the only source of private equity capital. Companies, however, shied away from them because many venture capital sources required giving up a major share of equity and perhaps control of the business. Few owners want to do that. Currently, however, there are myriad alternatives in the private equity market. To get an idea of the range of offerings in the private equity capital market - and the pros and cons of each - let's review four basic types.

Venture Capital Funds

In general, venture capital investors are mostly interested in funding start-up companies, development companies ('early-stage venture capital'), or companies with a proven technology that still lack a going-concern infrastructure ('later-stage venture capital'). Given the significant risk involved in many venture capital investments, it is not surprising that the investors expect a very high rate of return on their money, often as high as 50 per cent a year. This return accrues to the investor not in cash, but in the form of ownership. By the same token, venture capital investors will usually expect to exert significant control over strategic and policy decisions in the company.

How much of the company the venture capital investor expects to own is usually figured according to how long they commit the funds (typically three to five years) and what the expected future valuation of their investment will be. The longer they need to stay with the company to realize the expected valuation, the more ownership they will want in return. The faster the growth in value, the sooner they will reap their return and the less ownership they will require.

Hence, for small but very fast-growing companies, venture capital may be an attractive source of funds, possibly even the only one available. However, the high cost and the investors' preference for an early exit - via a sale of the company or an IPO - makes this kind of private equity financing less attractive for established companies.

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Institutional Private Equity Funds

For businesses that are established and have reached a certain level of revenues and profitability, institutional private equity capital offers a more attractive and less costly source. First of all, institutional private equity funds are much more flexible on the issue of control and hence more willing to consider holding a minority, or non-controlling, interest in the company. Second, unlike venture capital financing, which is primarily interested in funding growth, the institutional private equity funds can be used to satisfy the immediate liquidity needs of shareholders, not just growth needs.

Finally, by providing an alternative or even a supplement to bank borrowing, this form of financing does not weaken the balance sheet. On the contrary, it strengthens the balance sheet by leaving open the possibility of future borrowing from banks (which impose a limit on credit determined by company assets).

There are several thousand institutional private equity funds worldwide, each with different characteristics or specialties (ranging from health care to automotive) and size preferences for investments (say, over and under $50 million for each deal).

The majority of the capital inside institutional equity funds comes from financial institutions, whose investment cycle is typically five to seven years. Hence, most institutional private equity funds will want to exit their investment after five to seven years. Their exit will usually happen in the form of a refinancing or a buy-back of the shares owned by the fund. This form of equity financing is thus a very attractive one-time capital solution for businesses.

Institutional private equity funds have one major drawback. Since investors want to exit their investment after five to seven years, they would not allow funds to be used for ongoing liquidity programs for shareholders who wish to cash in stock in the future.

Boca Comm Private Equity Case Study

Situation

A first-generation family owned chemical company that was making the transition to a new generation of leaders.

Company Needs

- Provide liquidity for the older generation
- Ensure growth capital for the development of the company under the second generation
- Maintain long-term control

Solution

An institutional private equity fund was invited to buy stock from the first generation and to invest additional funds in the company. With supplemental funds in bank debt, the company was launched on a new growth path under the second generation, while satisfying the liquidity needs of the older generation.

Results

After five years, the younger generation was able to buy back the institutional private equity shares, bringing the company back to 100 per cent ownership. A great investment for the institutional private equity fund, and a successful transition for the business.

Buyout

A buyout private equity fund typically targets the acquisition of a significant portion or majority control of businesses which normally entails a change of ownership. Buyout funds ordinarily invest in more mature companies with established business plans to finance expansions, consolidations, turnarounds and sales, or spinouts of divisions or subsidiaries. Financing expansion through multiple acquisitions is often referred to as a "buy and build" strategy.

Investment styles can vary widely, ranging from growth to value and early to late stage. Furthermore, buyout funds may take either an active or a passive management role.

Special Situation

Private Equity Special Situation Funds invest in ranges more broadly, including distressed debt, equity-linked debt, project finance, one-time opportunities resulting from changing industry trends or government regulations, and leasing. This category includes investment in subordinated debt, sometimes referred to as mezzanine debt financing, where the debt-holder seeks equity appreciation via such conversion features as rights, warrants or options.

Family or Private Individual Equity Funds

Over the last decade, the number of family or private individual offices, in which wealthy families pool their resources and invest as a group, has multiplied. With the price-earnings ratios of many publicly traded companies peaking, moreover, many of these families are seeking to invest in other places besides the stock market. Relatively new funds are springing up to regroup the available investment capital these offices are looking to invest in private equity.

Most of the investors in equity funds are families or individuals with taxable income of various kinds. This makes them much more sensitive to differences in tax rates between, say, ordinary income and capital gains. Because they often prefer to defer capital gains tax, for example, they tend to maintain a long-term horizon on investing. That makes them more attractive to businesses than institutional equity funds as a source of both growth capital for the business and long-term liquidity programs for the shareholders.

This flexibility is particularly important for multiple-generation companies approaching a succession. Whenever such generational transitions occur, stock is often redistributed, the number of shareholders increases, and liquidity demands start to occur. The equity fund becomes the long-term financial partner to the family and to the business.

Mezzanine Funds

The least expensive source of private equity capital for businesses is the so-called mezzanine fund. A mezzanine fund lends subordinated debt to companies. The investment is subordinate in the sense of being second to bank debt in terms of risk and priority. Bank debt has to be repaid currently and is secured by assets or has some restrictive covenants; subordinated debt has very few covenants, does not have to be paid back currently, and is totally unsecured. This makes it a 'quasi-equity' instrument.

Compared with other sources of private equity, mezzanine debt is more like bank debt. It carries a specific interest rate, typically much higher than bank debt. And the client company does not give up equity ownership except in the form of warrants or other add-ons to the debt instrument. The high annual interest payment due on subordinated debt (between ten and 17 per cent) makes it less attractive for a company seeking to preserve its annual cash flow for growth. In addition, since this form of financing usually has a fixed time limit of five to seven years, at which point the principal has to be repaid, it is most appropriate for funding one-time, immediate liquidity needs of shareholders.

The main advantage of mezzanine financing is that it costs less than equity funds, institutional equity funds, and certainly venture capital. Lastly, it does not require immediate control over management decisions, though the mezzanine investors may want certain assurances about the company's strategy and its implementation.

The Uses of Private Equity Funds

	Venture Capital Funds	Institutional Equity Funds	Equity Funds	Mezzanine Funds
Growth Capital	Yes	Yes	Yes	No
Immediate Liquidity	No	Yes	Yes	Yes
Ongoing Liquidity	No	No	Yes	Yes
Expected IRR	25%	20%	17%	

Above, the advantages and disadvantages of different private equity sources or funds. The generally expected investor rate of return (IRR) of each is shown along the bottom. The percentage returns are pictured as a continuum, since the upper end for one type of fund is often close to the lower end of the next.

You are in Good Company

Some of the better known, early venture-backed companies include:

Digital Equipment Corporation (which went public in 1968 valued at US$37 million after Digital's original funding of US$70,000 in 1959),

Federal Express

Apple Computer

PRIVATE EQUITY FINANCE BACKGROUNDER

Boca Comm: Our Progress

1981	Initiation of operations by the founding partners of the firm, simultaneously in USA and France
1980s	Advisory role to IBM in personal computer R&D (France) and fabrication (Boca Raton Florida USA)
	Advisory and execution roles in AT&T's East Africa intercontinental telecommunications deployments (Kenya, Uganda, Sudan, Zimbabwe)
1990s	Development of structured due diligence methodologies for engagement support of 'Big 6' (Andersen, Coopers, Deloitte, Ernst, KPMG, Price) privatization client valuations in emerging markets (Asia, Australia, Europe, Americas)
	Emerging market support worldwide to nascent USA-and UK-based LBO firms
	First government advisory services contract with City of Tampa Florida, followed rapidly by consultative engagements arranged by The Interamerican Development Bank and The World Bank—in Guyana, Argentina, Panama; then throughout Central & South America
	Internal Boca Comm IT and telecom systems relocated to Internet backbones
2000s	Restructuring, realignment, outsourcing of the firm's service delivery model processes
	Formation of pure financial advisory services practice group concentration
	Development and implementation of risk mitigation strategies and tools specific for emerging market finance solutions
	Incorporation of Islamic finance strategies

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About Boca Comm

Boca Comm identifies, structures and executes diverse and innovative public and private market transactions for corporations, financial institutions and governments. Transactions include mergers, acquisitions, divestitures, the issuance of equity or debt capital, or a combination of these. We specialize in small– and middle- market private transactions across most sectors, concentrating in challenging or emerging markets worldwide.

Boca Comm Presence

- Every continent of the globe
- 45 Global Markets
- 600 Firm-wide Staff and Affiliates

Boca Comm seeks to provide our clients with the broadest possible range of opportunities from around the world. Our global relationships, coupled with our unique understanding of local economies, industries and cultures, help us consistently deliver high quality advice and service time and again.

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