



**Private Equity Debunked**  
**The Myths, the Truths, the Opportunities**  
**February 25, 2014**

# Private Equity – Overview

## What it is

- **Private Equity investors raise capital from limited partners, and the investment professionals (who serve as the General Partner) deploy that capital by investing in private investments into (typically) private companies**

## Types

- **Private Equity generally encompasses the following types of investment strategies:**
  - Buyouts
  - Growth Capital
  - Restructuring
  - Special Situations

## Benefits

- **Over the last dozen years, Private Equity has greatly outperformed both Venture Capital and Public Markets (stock market) investing**
  - Less volatile (not looking at daily market fluctuations)
  - Actively managed
  - Higher historical returns

## Drawbacks

- **Private Equity Investing does have some drawbacks:**
  - Investments in private equity are not immediately liquid
  - Ability to invest through retirement accounts mitigates this drawback
  - Once you commit, you are committed

## What to look for

- **There are some hallmarks of good Private Equity firms:**
  - Alignment of interests
  - Experienced General Partners who know the market
  - Reasonable fee structure
  - A strategy that is differentiated and makes sense

**Why It Exists**

**Why Investors Like It**

# Private Equity – Myth vs. Reality

MYTH	REALITY
Investors only like technology, biotech and clean energy companies	Investors that invest in every sector of the economy – you just have to identify the right one
Investors want to own the majority position in my business	Some investors require control, others take only minority positions
Investors want to control my business	Investors do not like to get involved in day-to-day operations unless current management is experiencing problems
Investors will force me to sell the business in 5 years	Investors require liquidity but there are multiple ways to achieve it other than a sale of the business
PE investments are only available to wealthy individuals	Investors need to be accredited. Each PE firm establishes their own minimum investment criteria.
PE firms expect unrealistic returns on their investments	Returns are risk adjusted for the nature of capital provided i.e. growth, buy-out, venture, distressed
Investments in PE funds are illiquid	True! You will need to wait for liquidity until the PE fund sells the portfolio companies

# Institutional Asset Allocation Strategies

- Are highly diversified into alternative investments
- Allocate 12-14% of assets to Private Equity
- Compensate asset managers based on success

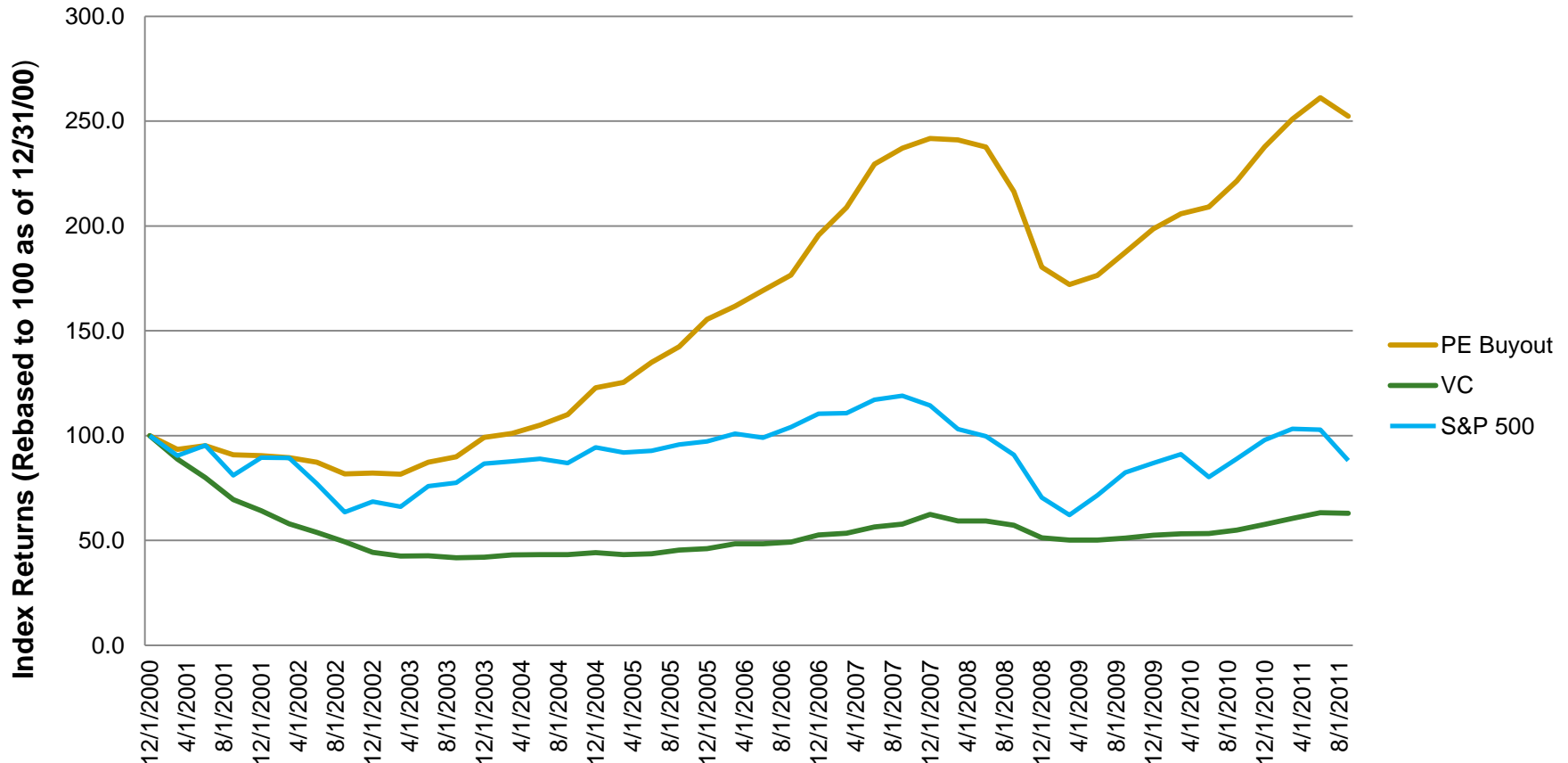
CALPERS	%
Public Equities	50%
Fixed Income	17%
Private Equity	14%
Real Estate	8%
Real Assets/Timber	10%
Hedge Funds	2%
Inflation	3%

Stanford Endowment	%
Public Equities	37%
Fixed Income	10%
Private Equity	12%
Real Estate	16%
Real Assets/Timber	7%
Hedge Funds	18%

Harvard Endowment	%
Public Equities	36%
Fixed Income	9%
Private Equity	12%
Real Estate	9%
Real Assets/Timber	14%
Hedge Funds	16%
Inflation	4%

# Private Equity is NOT Venture Capital

## Private Equity Outperforms Venture Capital and S&P 500



Footnotes: 1. As of March 2012 – Source: Preqin (Latest Data Available)

2. Capital IQ

3. Venture Capital and Private Equity returns are averages; DCA returns are top-quartile returns, and therefore considerably higher

**When it is a Good Solution**

# When is Private Equity a Good Financing Alternative?

- Business has solid and consistent cash flow
- Business has solid growth prospects
- Capable and experienced management team
- Limited customer concentration or other business risks
- Willingness to sell or recapitalize the business in 5 +/- years





## Example - Recapitalization / Partial Liquidity

- Minority Investment (10-49%)
- Capital to buy out partner, Minority Shareholder, or Partial Liquidity to Primary Shareholder(s)
- PE Firm becomes a partner with Management to increase value of Company over 5 years
- Partial Liquidity today (diversify risk), with still some skin in the game to share in value created over 5 years
- You remain in control
- Get benefit of PE value-add
- Align your interests with PE professionals who can help guide successful sale process



## What Investors are Looking For

# Typical Private Equity Investment Perspective

- Management Team
- Market Opportunity
- Sustainable Competitive Advantage
- Competitive Landscape
- Economic Drivers and Financial Model
- Scalability
- Valuation
- External Risks (-)
  - Regulatory
  - Economic
  - Geo-political
  - Concentration
- Alignment of Interests re: Exit



# Management Team – Why This Team?

- Domain Knowledge and Expertise
  - Depth and Breadth
  - Network
- Relevant Operating Experience
  - Current Roles and Responsibilities
  - Prior Assignments
  - Demonstrated Decision Making
- Track Record
  - Results – Success and Failure
  - Lessons Learned
  - References
- Fit – Complementary / Prior Experience Together
- Current Organization Chart / Gaps
- Board/Advisors



# Market Opportunity – Why this Market?

- Customer Value Proposition – Why Do They Care?
  - Save Time
  - Save Money
  - Increase Revenues
  - Decrease Costs
- Size of Market
  - Addressable Market and Segmentation
  - Market Share
  - Expansion / Extension / Adjacent
  - Market Research Reports
- Time to Market (2<sup>nd</sup> Mover Advantage)
- Differentiation – Value Proposition
  - Unique Attributes
  - Sustainable Attributes
  - Intellectual Property
    - Registered / Unregistered



# Market Opportunity – Why This Market cont'd

- Go to Market Strategy
  - Direct / Indirect
  - Internet
  - Channel
  - Customer Segmentation
  - Models
    - Sales Cycle
    - Quota
    - Organizational Structure
    - Commission Structure
    - Cost of Customer Acquisition
  
- Pipeline
  - Funnel
  - Win / Lose – Why?
  
- Customer References
  - Selection Criteria
  - Alternatives Considered
  - Ease of Use / Relationship



# Competitive Landscape – Why Do You Win?

- Current Competitors
  - Identified/Unidentified
  - Magic Quadrant
  - Industry Analyst Reports
- Competitor Characteristics
  - Offering
  - Positioning
  - Distribution
  - Resources
  - Intellectual Property
- Anticipated Response
- Potential Competitors
- Structural Risk



# Financial Model – How Do I Make Money? How Much? When?

## Assumptions

- Key Drivers
  - Rate and Cost of Customer Acquisition
  - Production / Delivery Capacity
  - Roadmap (Technology / Product)
  - Third Party / Regulatory Approval
- Identify Milestones
- Sensitivities - Leverage
  - Rate of Growth
  - Margin Expansion
  - Units Sold
  - Selling Price
  - Cost of Sales
  - Expenses
  - Headcount
  - Intellectual Property Development
- Dependencies
- Innovation Required





# Financial Model – How Do I Make Money? How Much? When?

- Complete Financial Statements
  - Income Statement
  - Statement of Cash Flows
    - Working Capital
    - Capital Expenditures
  - Balance Sheet
  - Format
    - 3 Years
    - Monthly
    - Assumptions / Triggers
- Benchmark Against Industry / Competitors
- Next Round of Financing
  - Catalyst
  - Timing
  - Amount
  - Source



# Valuation - Investor Sets the Price. Company Selects the Investor.

- Investor Return Required
  - Sector and Stage
  - Holding Period
  - Rate of Return (Cash on Cash +IRR)
- Current Capitalization Table
  - Prior Financings and Terms
  - Adequacy of Option Pool
- Methodologies
  - Public Company Comparables and Precedent M&A Transactions
    - Both Methods Yield Multiples of Revenue & EBITDA
  - Discount of Pro-Forma Financial Statements
    - Investor's Risk Adjustment to Company Plan
- Pre- vs. Post-Money Value
- Likely Exit – Who?
  - Timing
  - Acquisition / Merger
  - Recapitalization



# Investor Selection Criteria – Traits and Attributes

- Role of Friends and Family
- Personality
  - Fit
  - Relationship with other CEOs / Boards
  - Commitment / Participation
- Experience
  - Relevance
  - Operating / Financial / Technical
- Value Add
  - Relationships
    - Customers / Potential Customers
    - Distribution Channels
    - Strategic Partners / Acquirors
    - Operating / Financial / Technical
    - Other Investors
  - Other Members of Investor Team
  - Management and Governance
- Ability to Fund Future Rounds



# Exit Strategies – Begin With The End In Mind<sup>1</sup>

- Sale to Strategic Acquiror
- Sale to Financial Acquiror
- Redemption by Company
- Initial Public Offering



<sup>1</sup>Stephen Covey – “7 Habits of Highly Effective People”

# The Process – What's Required

- Term Sheet
  - Governance
  - Preferences
  - Required Insurance
- Formal Due Diligence
  - Business
    - Confirmatory
    - Competitive Landscape
  - Legal
  - Financial
    - Historical
    - Budgets
    - Projections
    - Unrecorded Liabilities
    - Capital Expenditures
  - References
    - Management
    - Customer



## Next Steps – What's Required cont'd

- Drafting Definitive Documents
  - Major Terms Negotiated in Term Sheet
  - Customary Agreements
    - Stock Purchase Agreement
    - Co-Sale and Right of First Refusal
    - Voting Agreement
    - Investor Rights
    - Amended and Restated Articles
  - Transaction Counsel
  - Executive Employment Agreements
- Closing
- Execution Against Plan



# Questions?

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