Structuring a venture capital deal

Venture capital covers a broad range of transaction types. This article considers the risks of various types of deal for the investor, and shows how these translate into required returns. It then focuses on one particular type of deal : the management buyout. Using a real-life example, it shows how deals can be structured and why they can be potentially lucrative for the managers who undertake them.

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Introduction

Venture capital can, in its broadest sense, include all equity-based funding invested privately (that is, not through a stock exchange) by non-management investors. The term encompasses everything from private equity through to business angel finance. It includes investment in types of deal from high risk start-ups to leveraged buyouts of established businesses.

This article focuses mainly on management buyouts and buy-ins, but the points raised are relevant to all venture capital transactions.

The players

In any venture capital transaction, there are at least two parties : the entrepreneur(s) and the venture capitalist(s). Most transactions involve more players. If the entrepreneurs are undertaking a buyout, then the vendor will have a significant part to play. Also, debt finance is generally used, possibly in several tranches, which brings one or more bankers into the equation.

The key thing to remember in structuring a deal is that each of the parties has different requirements to meet :

- The management need their deal to be funded, and generally want as high as proportion of the company's equity as possible, even though they may have little cash to invest.
- The venture capital investors are looking for an investment that will enable them to exit with a high internal rate of return (IRR).
- The vendor may seek to make a profit on the deal, or may be in need of a swift injection of cash, or may have non-financial objectives such as protecting the future of the company.
- Banks will lend if they can be assured that they have reasonable security for their investment.

Within these parameters, an attempt is made to design a deal to suit everyone.

Risk and return

The various types of venture capital transaction are defined in the appendix to this article.

Different types of deal carry different levels of risk : the perceived risk of a transaction drives the return that the participants require.

Figure 1 shows how some types of venture capital deal fit onto the risk–return continuum.

The categorisation of risks on the basis of transaction type is not an exact science. For example, in certain circumstances, expansion finance could be riskier than a particular management buyout (MBO), or a management buy-in (MBI) may be riskier than a rescue.

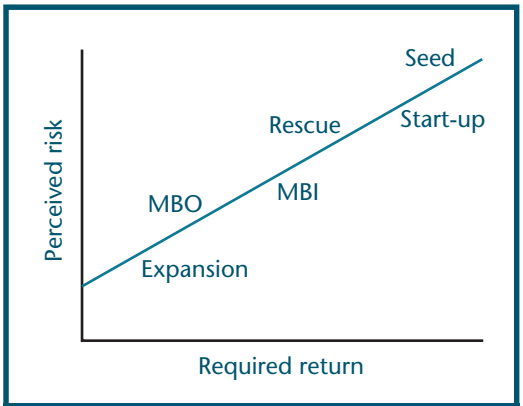

Figure 1 Venture capital transactions and risk–return continuum

The key issue is that of how the investors perceive the risk of each investment. Transactions with a higher perceived risk need to generate a higher return for their investors; if this is not possible, the deal will not be financed.

The return will often be achieved through the use of financial engineering techniques, and these are discussed in the next section.

Structuring a management buyout

Deal structuring can be simplified as a series of steps :

1. Determine how much finance is needed. This should be the total finance, which must be sufficient to cover the deal price, the working capital requirements, future cash requirements and the deal fees.

2. Ascertain how much of that finance can be taken as debt. The reason for this is that debt is a cheaper form of finance than equity, and the gearing of the deal will affect the equity returns, as shown below. One useful guide is to look at the projected profit before interest and tax (PBIT), and determine how much bank interest the company could afford to pay with the interest cover still being at a level acceptable to its potential financiers. This figure can be used to calculate the amount that could be borrowed. There is no 'standard' amount of debt that a deal can support. It will depend on the specific context, the asset backing of the business, and the amount and quality of its cash flow generation. It may also depend on the economic climate. When banks have a lot of money to invest, for example, interest cover covenant requirements tend to be lower. A final check is to ensure that the company could afford to support repayments on the amount borrowed, and to see what the asset cover and balance sheet gearing would be.

3. Determine how much funding the management is able to invest. Investors generally expect this to be at least one year's salary, and often more. Management may be able to negotiate with the venture capitalists to balance the amount that they invest up front against the amount that they take out as contracted salary in the first few years.

4. Once the total funding needed, the level of debt, and the management contribution are known, the balancing figure is normally supplied by the venture capital institutions. This funding is commonly invested partly as preference shares and partly as ordinary shares, as explained in the next section. However, the parties are not limited just to these types of financial instrument; various debt hybrids or classes of share may be used to structure the deal.

Determining the equity split

In March 1993, there was a management buyout of MDIS, a computer business owned by McDonnell Douglas. The division was bought out for £125 million at a time when the business appeared to be facing an adverse economic climate.

As shown in *Analysis* 1, the venture capital institutions had to invest £64 million in the buyout as compared with the management's £1 million.

Analysis 1 MDIS management buyout

	£M
Total funding requirement	125
Financed by bank loans	60
To be financed by equity	65
Funding introduced by management team	1
Funding introduced by venture capitalists	64

Differing levels of investment could be a problem if the ordinary shares were issued pro rata to the investments. In this example,

the management would have ended up owning one-sixty-fifth of the company (less than 2%). This would have been unlikely to inspire them to commit their futures to the business and give their all to ensuring its success.

In this type of situation, therefore, a method has to be devised to give management proportionately more of the equity than their investment alone warrants. This could be done by differential pricing.

In this example, the management could buy their ordinary shares at £1 each, but the institutions might pay £10 per share. Management would then own 1 million shares, and the institutions would own 6.4 million shares. Management would then have 13.5% of the equity.

This would achieve the desired effect of giving the management a bigger stake, *but* it could have serious consequences later on. What would happen if a buyer offered to acquire the company, offering £4 per share ? The management would obviously want to accept the offer, as they would be making a profit of £3 per share, but the institutions would reject it, as they would make a loss of £6 per share. Differential pricing of shares can lead to undesirable conflicts of interest.

The way in which the MDIS deal was structured was that the institutions put in their £64 million in two separate instruments : ordinary shares and preference shares. (This is the most common method of resolving this type of problem.)

Analysis 2 shows how this was done. £58.3 million of the institutional venture capital was invested in the form of preference shares, and only £5.7 million was invested as ordinary shares. On any sale or flotation of the company, the preference shares were be paid off first, at par. The balance of the sales price was to be divided between the management and the institutions, with management receiving 15%.

In any deal, the decision as to how much of the institutional capital goes in as ordinary shares and how much as preference shares is a matter for negotiation. One figure which is used to determine how generous, or otherwise, the institutions are being is known as the *envy ratio*.

In the MDIS case, the institutions put in a total of £64 million for ordinary shares and preference shares to buy 85% of the equity. Management put in £1 million and received 15% of the equity. This 'valued' the company as shown in *Analysis* 3.

Analysis 2 Structure of MDIS deal

	Equity	Initial investment	Value on sale at £250M
	%	£M	£M
Total price paid/received		125.0	250.0
Bank loan (£15M repaid during year)		60.0	45.0
Balance for equity		65.0	205.0
Institutional preference shares		58.3	58.3
Balance for ordinary shares		6.7	146.7
Split of ordinary investment:			
Management	15	1.0	21.9
Institutions	85	5.7	124.8

Analysis 3 MDIS envy ratio

		Initial investment	Proportion of investment	Value of company
		£M	%	£M
From institutions' point of view	*A*	64.0	85	75.2
From management's point of view	*B*	1.0	15	6.7
Envy ratio	*A*/*B*			11.2×

The higher an envy ratio is, the better is the deal for management. In any transaction, the envy ratio is affected by

- how keen the venture capitalists are to do the deal;
- the competition they are facing;
- economic factors.

It is very difficult to say what a 'typical' ratio is. This author was involved in a transaction a few years ago in which the envy ratio was almost 40×, as compared with a ratio of 15× offered by one of the competing venture capitalists.

(Interestingly, the competing venture capitalist then participated in the buyout, so it obviously thought that the transaction was worth doing at a much higher price than it had offered !)

MDIS was floated a year after the buyout, at an enterprise value of £250 million. As shown in *Analysis* 2, this meant that the management had turned their £1 million investment into almost £22 million. The institutions did less well proportionately, but their invested £64 million realised £183.1 million, an excellent return.

However, the management's (and possibly some of the institutions') high returns existed only on paper. Within a few months of the flotation, the share price of MDIS had slumped owing to poor trading conditions, and management never actually realised their £22 million.

(The MDIS buyout financial data were taken from the *Daily Telegraph*, 1994.)

Tweaking the terms

Dividends

One way in which management's desire for a higher percentage of the equity can be met is for the institutions to increase their potential IRR by taking a dividend return as well as a capital gain on exit.

Dividends can also be used as a tactic to ensure that the institutions do actually achieve their exit.

In a company which is known to be cash generative, the dividend terms might be set such that the institutions' ordinary shares (or sometimes all of the ordinary shares) receive an extra dividend that starts at, say, 10% of distributable profits and rises annually by 5% or more.

The payment of such a high dividend can be used to focus management's mind on the possibility of an exit, so that they can realise their potential capital gain before the institutions have taken it all out by way of dividends ! Even if there is not an exit, the institutions still get their high IRR, through the yield.

Ratchets

There are times when management and the institutions cannot agree about the future potential of the business, and thus its value.

Management might want a high percentage of the equity, believing that the company will do very well in the future. However, the institutions might argue that there was no guarantee that the company's performance would improve, and so they needed a high equity stake to ensure their return.

A ratchet can be the answer to this type of problem.

A ratchet is a device that enables the proportion of equity held by management to be altered depending on what profits the company achieves (or depending on any other specified variable).

A *positive ratchet* starts management at a low equity percentage with the incentive that should they perform well, their percentage will be increased. A *negative ratchet* starts them at a high equity percentage, but they have to forfeit some shares if the company does not meet its targets.

Ratchets solve the immediate issue of conflict resolution between the parties at the commencement of the deal. However, in many cases, they lead to far greater problems in the future when the ratchet is (or is not) triggered.

This article has dwelt on deal structuring for buyouts and similar transactions, but many of the principles apply to other types of venture capital deal. There is no 'right answer' : different parties could arrive at very different structures for the same deal. The important point is that, as far as is possible, everyone's needs are met, and all the parties see the transaction as 'fair'. After all, the completion of the deal is only the start of a long relationship.

Table 1 BCVA venture capital transaction definitions

Types of transaction	Definitions
Seed	Very early stage finance that allows a business concept to be developed
Start-up and early stage	Used to develop the company's products and fund its initial marketing (early stage finance is for companies that have commenced operations but are probably not yet profitable)
Expansion	Used to grow and expand an established company (also known as development or growth capital)
Bridge financing	Short-term venture capital funding provided to a company generally planning to float within a year
Refinancing bank debt	Used to reduce a company's level of gearing
Secondary purchase	A venture capital firm acquires existing shares in a company from another venture capital firm.
Replacement equity	Allows existing non-venture-capital investors to buy back or redeem part or all of another investor's shareholding
Rescue/turnaround	Enables a company to resolve its financial difficulties or be rescued from receivership
Management buy-out (MBO)	Enables the current operating management to acquire, or purchase a significant shareholding in, the business
Management buy-in (MBI)	Enables a manager or group of managers from outside a company to buy into it (a combination of a buyout and a buy-in is known as a BIMBO)
Institutional buy-out (IBO)	Enables a venture capital firm to acquire a company, following which the incumbent and/or incoming management is given or acquires a stake in the business (the deal differs from an MBO in that it is driven by the institution(s) rather than the management)
Leveraged build-up (LBU)	A venture capital firm acts as principal to buy a company with the aim of making further relevant acquisitions to develop an enlarged business group

Appendix : types of venture capital deal

The British Venture Capital Association (BVCA) classifies its members' equity investments under the headings shown in *Table* 1.

Not all the members of the BVCA undertake each of these types of investment; institutions specialise in different types of deal. For example, about 40 of the BVCA's current 287 members state that they will invest in seed investments, compared with over 100 who will invest in MBOs.

Within these categories, members also screen prospective investments by

- size (many will not invest less than, say, £5 million);
- industry (some will only invest in specific industries, and others reject certain sectors);
- geographical location.

Further reading

- 'BVCA'
  (2001) http ://www.bvca.co.uk/
  (accessed 15 June 2001)
  Excellent website of the British Venture Capital Association that gives facts and figures on the industry, and also has a searchable database that can be used to find prospective investors.
- **'Financial instruments'**
  Moir, L *Management Quarterly* Part 8
  (2000) pp 25–30
  Explains the characteristics of various types of financial instrument.