**Private equity funds and the typical structure of private equity backed acquisition**

This section will focus on the purchase of the business and assets or the issued share capital of a company by a private equity fund. It will be funded by equity from the private equity fund together with a management team and further funding from banks or other institutional lenders

**Introduction**

A Private Equity Fund (**PE Fund**) is: fund set up for the purposes of investing in unlisted securities.

Note: This may include ‘taking private’ a listed company through a successful takeover process.

In its simplest form, a private equity fund (the ‘**Fund**’) gathers money from a number of different investors and then seeks out opportunities for investing that money in order to make a return (both in income and capital growth) on that money, for the investors. Investors in private equity funds include high net worth individuals and institutional investors such as banks, pension funds and insurance companies. At any time, a single Fund will hold investments (usually shares and loan notes) in a number of different companies.

These companies are commonly referred to as the Fund’s ‘portfolio companies’.

A Private Equity “House” will have a number of PE Funds all at different stages of the life cycle of a fund e.g.

* Fundraising;
* Acquisition;
* Operation;
* Exit; and
* Return on proceeds and winding up.

Throughout this knowledge stream we will refer to a PE Fund rather than PE houses for simplicity.

**What fund vehicle is used for a PE Fund?**

The typical structure used by a PE Fund in the UK is a:Limited Partnership

The detail of this structure is discussed in detail in the next section of this knowledge stream

The key elements of the structure are :

* A **General Partner** (GP): The GP has full responsibility for operating the limited partnership. It has unlimited liability for its debts and obligations.
* **Limited Partners** (LPs): The LPs have limited liability unless they take part in management of the partnership business.
* PE Funds also have a **limited lifespan** (typically 10 years plus 2 extensions of 1 year) within which investors’ money will be returned to them (as the structure is closed ended).

The key benefits of using this structure for a fund are

* an investor role with limited liability and no active management rights;
* flexibility and privacy – as the agreement forming the partnership will not be public and accounts are not required to be filed; and
* tax transparency.

**Types of private equity activity**

Generally speaking, there are three main types of private equity (or private capital) activity:

* the funding of a new business with little or no track record: **Venture Capital**;
* the funding of an existing, more mature business to help it develop: **Development Capital**; and
* the funding of purchases of established businesses where there is still a margin for improvement of performance (somewhat confusingly, the term private equity or PE is often used synonymously with these transactions. However, the term **'private capital'** is becoming a more common general term).

For the purposes of this knowledge stream, we will be focusing on the third of these types of private equity activity. These transactions are often referred to as either a:

* Management Buy-out (‘**MBO**’): this is where the **existing management** of a company or business, together with the Fund, buy the company or business from its existing owner;
* Management Buy-in (‘**MBI**’): this is where a **new management team** is assembled for the purposes of running the company or business after its acquisition by the Fund from its existing owner;  
  Institutional Buy-out (‘**IBO**’): this principally driven by the Fund with a management team (who may be existing or new or a mixture) taking a smaller stake of equity

**Point to Note:**  Although the terminology focuses on management, in most cases, the transaction is initiated and driven by the Fund rather than management.

**The acquisition vehicle**

The Fund will set up an **acquisition vehicle** (a newly incorporated company or group of newly incorporated companies) into which it invests which will acquire the target company or business (‘**Target**’). The company into which the Fund invests is known as ‘**Topco**’ in this knowledge stream. Often, the Fund will set up a second company as a wholly owned subsidiary company of Topco that will be the acquisition vehicle (‘**Bidco**’). The corporate structure is typically tax driven and can be complex - often involving more than two newcos in the chain and/or companies incorporated in jurisdictions outside of the UK. (See diagram on next slide)

In this knowledge stream, we will be mainly considering a **two newco structure.** Following the buy-out, the management (whether existing or new management) (‘**Management**’) will devote their time and efforts to make the bought-out business successful. Sometimes, the Management will be compensated for their time and effort by means of salary and bonuses alone but frequently the Management will also subscribe for equity shares in Topco so that if the venture proves successful, they can receive a proportionate part of the capital gain in value of the bought-out business.

Virtually all buy-outs use a certain amount of ‘**leverage’ or debt finance**, using the assets of Target as security. Sometimes you will hear of a buy-out being referred to as a leveraged buy-out (**‘LBO’**). This debt funding sits alongside the funding put into the structure by the Fund (so-called ‘**equity funding’**)

**Standard buy-out structure: Before completion**

Prior to completion, lawyers acting for the Fund (where the transaction is initiated and driven by the Fund) will arrange for the transfer of two shelf companies (‘**Topco’ and ‘Bidco’**) into the ownership of the Fund by transferring the subscriber shares in Topco to the Fund and by transferring the subscriber shares in Bidco to Topco (so that Bidco becomes a wholly-owned subsidiary of Topco).

If the transaction is being driven by Management their lawyers will set up Topco and Bidco with Management holding the subscriber shares.

The bulk of the investment in Topco by Management and the Fund and in Bidco by the bank will not occur until completion. Bidco will be the company which actually purchases the Target. Until completion, the Target is still owned by the existing owners **(‘Seller(s)’).**

**Standard buy-out structure: After completion**

At completion, the funding of Topco and Bidco, the acquisition of shares/assets in the Target by Bidco and the granting of security by Bidco (and Target, where the shares of Target have been acquired) to the bank will happen simultaneously.

The investment from Management and from the Fund will go into Topco. This money will be passed from Topco to Bidco, either by way of an intragroup loan or by Topco investing in further shares in Bidco.

The bank will lend money to Bidco. In return for the loan to Bidco, the bank will expect to be given security over the assets of Bidco and the Target (where the shares of Target have been acquired). Once the monies are in place, the acquisition of Target by Bidco can be completed. The bank will usually expect Bidco’s borrowing to be guaranteed by Target (where the shares of Target have been acquired).

An illustration of the structure is on the next slide.

This structure illustrates a share sale. On an asset sale Bidco would purchase the assets of the Target and the seller would be the Target.

*Alt text: The slide illustrates the****flow of funds and ownership structure****in a private equity-backed buy-out after the transaction has been completed. It includes a****diagram****showing the relationships and financial flows between the entities involved:*

***Entities in the Diagram:***

* ***Private Equity Fund***
* ***Management***
* ***Topco****(holding company)*
* ***Bidco****(acquisition vehicle)*
* ***Target****(the company being acquired)*
* ***Seller***
* ***Bank***

***Key Relationships and Flows:***

* ***Private Equity Fund and Management****invest money into****Topco****.*
* ***Topco****passes funds to****Bidco****either through:*
  + *An****intragroup loan****, or*
  + ***Equity investment****(shares in Bidco).*
* ***Bank****lends money directly to****Bidco****.*
* ***Bidco****uses the combined funds to****acquire the Target****from the****Seller****.*
* ***Security****is granted by****Bidco****and****Target****(if shares are acquired) to the****Bank****.*
* ***Guarantees****may also be provided by****Target****for Bidco’s borrowing.*

**Return on investment**

Whilst the Fund may well achieve an income return in the form of dividends or interest from Topco, the major return on the investment by the Fund will be the capital return achieved upon ‘Exit’. A successful Exit occurs upon one of the following occurring:

* the **IPO** of Topco on a recognised exchange; or
* the **sale** of Topco to a trade buyer; or
* a **secondary buy-out** (where one Fund buys from another) or further buy-out.

Most successful Exits occur between three and seven years after the acquisition of the target by Bidco. Where the venture proves to be **unsuccessful**, the Exit will probably be by way of either:

* a sale of the Fund’s equity in Topco to Management; or
* an administration or insolvent liquidation of Topco.

Continuation funds are growing in popularity. The structure of a continuation fund involves the formation of a new fund for the purpose of acquiring one or more assets from the original fund (which is nearing the end of its lifespan). This gives generally the LP the option to stay invested in the portfolio and recommit to a new fund.

**Summary**

* A private equity fund takes money from investors such as high net worth individuals, banks and pension funds and invests that money in companies to make a return.
* A management buy-out is where the current management of the target, with the help of external funding from a private equity fund and banks, buy the company or business from the current owner.
* A management buy-in is where a new management team is put together to run the target following the acquisition.
* An IBO involves the acquisition of a controlling interest in a company by an institutional investor (a private equity fund) and may include new or existing management.
* A buy-out will typically be structured using one or two shelf companies, ‘Topco’ and ‘Bidco’, or even more.