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Private Equity Guide for Businesses

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PRIVATE EQUITY GUIDE FOR BUSINESS OWNERS IN ETHIOPIA

Private Equity (PE) is fast becoming an important source of finance for small and medium sized businesses (SMEs) in Ethiopia. Examples of businesses that have accepted PE investment are far and between and the practice is relatively new. This guide is prepared for anyone, specifically for entrepreneurs and business owners, wishing to get some basic understandings on the working of PE firms, PE financing, PE investment raise processes, the benefits of PE investment, what do PE firms look for and how to find the best fit PE investor.

Learning Outcomes:

1. What is Private Equity?
2. Why PE investment is different from debt and founders' equity?
3. Know your business and your numbers
4. Know your capital structure
5. Understand the PE investment process
6. Retain the services of professional advisors

Quick Introduction into PE

1. Business owners and entrepreneurs must understand their company's financing structure, its strengths and pitfalls and exhaust other possible forms of financing before considering PE investing.
2. PEs are managed by individuals or companies ("General Partners") who pool funds from individuals and institutions ("Investors" or "Limited Partners") with the aim of investing those funds to businesses in exchange for an ownership and stake and share of profits.
3. PE investment is different from debt and also may differ from the other owners' equity stake in the business. As such,
   a) Preparing for and undergoing through a PE investment process is often rigorous;
   b) Concluding an agreement with a PE is fraught with numerous difficulties; and
   c) Attaining common goals and adhering to signed agreements is the most difficult aspects of managing relationships post PE investment.
4. Know your business means knowing your market, competition, product offering and your customers. Be able to position your offering, articulate your strategy clearly and know the numbers that drive your business.
5. Due diligence is an exercise that is investigative by its nature (like audit) to verify facts and assertions about your company. It can be intrusive. Be prepared to share information.
6. Valuation exercise is more like an educated estimate of the value of your business. And value of your business can only be established when an actual transaction is consummated.
7. Accepting PE investment is like getting married.

Common Misunderstandings about PE Investment:

1. We have been in business for many years and have seen it all. These PE people cannot be smarter than us. This is our playing field.
2. PE investment is like JV. PE investment is always equity. PE firms always share risks and rewards with us equally.

3. PE firms will accept valuation of our company. We paid lots of money for a renowned advisory firm to do our valuation.
4. Calculating the value of your business from the value of land and fixed assets; such as land owned by the business instead of the calculating value form the profits and cash flows of your business.
5. Assuming some of the people that you have heard to connect investors with business owners' ("the Delalas") as professional advisors.
6. Agreements with PE firms are mere formalities. Everything is going to be fine.
7. Assuming the relationship with PE firms as marriage of equals.

WHAT IS PRIVATE EQUITY?

Business Owner Perspective

Private Equity is a form of equity (or equity like instrument depending on structure) financing in exchange for shares representing a percentage stake in the business and share of profits.

Generally speaking, there is a limit to any business for going after debt funding, particularly bank loans. Beyond a certain limit, banks will not continue to underwrite loans unless the business can provide solid collateral support. Typically, it is difficult for businesses in Ethiopia get financing from banks for growth and expansion as there are various strict requirements. One form of providing collateral support that enables businesses to borrow more money from banks is securing PE investment.

PE Firm Perspective

Private Equity is a form of medium to long-term investment with the goal of making profit in the shares of growing or mature companies whose stocks are not publicly traded on a stock exchange.

PEs are managed by individuals or companies ("General Partners") who pool funds from individuals and institutions ("Investors" or "Limited Partners") with the aim of investing those funds to businesses in exchange for an ownership and stake and share of profits.

At the end of the investment period, PE's expect to exit from the investment. In most cases, PE's plan on exit before agreeing to any investment.

WHAT ARE THE DIFFERENCES BETWEEN FINANCING IN THE FORM OF DEBT, PE INVESTMENT, AND OWNERS EQUITY?

The differences between financing a business using debt, PE equity investment or owners equity is explained by the natural function of risk and reward system.

Debt (e.g. bank loan) has a fixed cost in a form of interest payments and repayment of the principal money borrowed. In exchange for the security of earning interest and repayment of the principal amount, a lender (e.g. a bank) will take a fixed interest payments and collateral to guarantee payment of the loan. The primary focus of a bank is the ability to generate cash flows to repay the interest and principal amounts of the loan and preservation of collateral.

PE investment typically has a variable return. If the business is successful, PE firms expect to gain significant returns from the investment, which could be costly for the business owners/entrepreneurs. However, if the business is not successful and assuming no guarantee is included in the structure, PE firms stand to lose all of their investment. What makes a PE investment different from owner's equity is how the investment terms are negotiated and structured.

PE's that negotiate deals to limit their downside risk (e.g. a structure that allows PEs to get paid ahead of owners and/or allows a return of x% of investment) should give up upside benefits to owners. Owners' equity has the most variable return and bears the highest risk. In exchange for ensuring bank loans are paid first and PE firms are paid second, owners' are expected to enjoy upside benefits.

WHAT DO PE FIRMS LOOK FOR?

PE firms come to Ethiopia attracted by macroeconomic indicators pertaining to past and present economic growth, future growth potentials, demographics, deal opportunities and entrepreneurial culture. They would typically have a good understanding about what is open for foreign investment and what is not open for foreign investment. PE firms understand the laws pertaining to doing business in Ethiopia, the degree of ease (or difficulty) of doing business, its taxation system, governance rules and type of investor protection provided. Once PE firms are on the ground looking for deals, this is what they would be looking for in the order of importance.

1. A great entrepreneur – overrides everything else – it is all about you, the business owner and the management team;
2. A great opportunity – demand, market potential and ease of availability of resources;
3. A great partnership – agrees to a deal, get to work, sustain a working relationship and facilitate exit.

HOW DO YOU PITCH YOUR BUSINESS TO POTENTIAL PE FIRMS?

Develop your "Elevator Pitch" about your business and rehearse as many times as you possibly can with your friends, colleagues and families. Elevator Pitch is a speech that should be delivered in the short time period of an elevator ride, usually in less than 60 seconds. In short, you should be able to describe your business, your business model, products/services and markets, how you generate money and how you spend money.

Once you get interested PE firms, the basic things you should be able to do are:

1. Articulate your revenue models, your cost structure, the market size and growth opportunities;
2. Explain numbers pertaining to your business, such as, figures pertaining to sales, costs and expenses, gross profit margin, net profit margin and operating cash flows;
3. Form a realistic expectation of your business in light with the current situation and competition;
4. Identify your investment need, how it is going to be deployed and how it will improve the financial performance of your business; and
5. Provide a compelling reason to the PE firms on why they should invest in your business.

It is important to note that PE firms look into several deals and choose the best entrepreneurs with strong opportunities to invest. How you prepare to woo a PE firm is a significant aspect of the investment process. Equally important is how you spend your time and effort in identifying the right PE firm that you can partner with. A pitch delivered to the right PE firm goes a long way into securing the needed investment.

HOW DOES THE PE INVESTMENT PROCESS WORK?

Once you pitch your business and a PE firm is interested in engaging with you. The typical process involves the following:

1. Getting to know each other – the goal of the first meeting is to get the second meeting – it is about the PE firm getting to know you, the entrepreneur. Equally, you should make the effort to get to know the PE firm.
2. Reach an understanding to start sharing preliminary information –this typically happens on or after the second meeting. Early on, the PE firm will be able to determine if this is the deal it wants to get into. The entrepreneur should equally make such assessment.
3. Develop the business plan and financial projections before approaching a PE firm.
4. Share historical financial information and respond to the PE firm's preliminary enquires.
5. Arrive at the valuation estimate of the business.
6. Negotiate a term sheet.
7. Undergo a due diligence process.
8. Close the investment.

WHAT ARE THE ESSENTIAL AREAS TO COVER IN YOUR BUSINESS PLAN?

Many businesses do not get the attention of PE firms because their plans have not been properly thought out, written down and developed. A business plan covering essential areas and its accompanying financial projections should be prepared to the highest standard before approaching a PE firm.

The executive summary is the most important section and is often best written last. It summarizes your business plan and is placed at the front of the document. It is vital to give this summary significant thought and time, as it may well determine the amount of consideration the PE firm will give to your detailed proposal. It should be clearly written and powerfully persuasive, yet balance "sales talk" with realism in order to be convincing.

Your business plan needs to be convincing in conveying your company's growth and profit potential and your team's prior relevant experience. It needs to clearly encapsulate your company's USP (i.e. its unique selling point – why people should buy your product or service as distinct from your competitors).

The summary should be limited to no more than two to three pages (i.e. around 1,000 to 1,500 words) and include the key elements from all the points below:

1. The market
2. The product or service
3. The management team

4. Business operations
5. Financial projections
6. Amount and use of finance required and exit opportunities

Financial projections are the detailed numerical depiction of your business plan. Developing a detailed set of financial projections will help to demonstrate to the PE firm that you have properly thought out the financial implications of your company's growth plans. PE firms will use these projections to determine if:

- Your company offers enough growth potential to deliver the IRR on investment that the PE firm is seeking.
- The projections are realistic enough to give the company a reasonable chance of attaining them.

PE firms will expect to see a full set of cohesive financial statements – including a balance sheet, income statement and cash-flow statement, for a period of three to five years. Do include notes that explain the major assumptions used to develop the revenue and expense items and explain the research you have undertaken to support these assumptions.

It is important to note that the financial projections may be used in **discounted cash flow (DCF)** calculations.

HOW DO YOU ARRIVE AT THE VALUATION ESTIMATE OF YOUR BUSINESS?

There are no right or wrong ways of valuing a business. There are several ways in which it can be done. The key is to understand the valuation methods used by the PE firm, discuss the merits and demerits of the application of specific valuation methods employed and work towards reaching a common goal.

Typical valuation methods employed by PE firms are DCF**.** Yet some PE firms may employ relative valuation methods or even decide to value the existing net assets of the business or their realizable value.

PE firms usually think in terms of an annual **internal rate of return (IRR),** a target overall return on their investments, and are calculated over the life of the investment.

The required IRR will depend on the following factors:

1. The risk associated with the business proposal;
2. The length of time the private equity firm's money will be tied up in the investment;
3. How easily the PE firm expects to realize its investment – i.e. exit through sale to outsiders or buyout by the entrepreneurs when funds are available; and
4. How many other private equity firms are interested in the deal (i.e. the competition involved).

Pre money valuation is the value of the business before investment from PE firm. The entrepreneurs and business owners are typically focused on the pre money valuation and the percentage stake they will have to give up to the PE firm.

Post money valuation is the value of the business after investment. The PE firm will be more focused on the post money valuation as it will be used as a benchmark for subsequent rounds of financing or indeed for its eventual exit.

WHAT IS A TERM SHEET?

Term sheet is an offer letter that the PE firm will send you when there is a strong interest and desire to partner with you, the entrepreneur / business owner, following the review and discussion of the business plan, initial investigation (due diligence) and enquiries, and negotiations on capital structure.

Term sheet sets out the general terms of the investment proposal, subject to the outcome of the formal due diligence process and other enquires and the conclusion of negotiations on the valuation of the company.

Term sheet, without being legally binding on either party save for certain sections, demonstrates the PE firms commitment to partner and shows serious consideration is being given to consummate an investment agreement. It is important to note that term sheet represents the private equity firm's preferred terms and not necessarily and indeed, unlikely at this early stage in negotiations, your preferred terms. The PE firm may change the terms as the due diligence process and negotiations progress, for example adjustments to the overall valuation etc.

The specific terms in the "term sheet" will be incorporated into the investment and shareholders' agreement at the end of the negotiation process. It is better for the term sheet to be as detailed and unambiguous as possible so that there are no surprises when the eventual investment and shareholders agreement have been drafted for you to sign.

WHAT IS DUE DILIGENCE?

Typically, a start of due diligence process is when PE firms request the managers of the business to create an electronic data room where all due diligence pertinent information will be compiled and made available. Since due diligence could be an expensive exercise, PE firms will not undertake a thorough formal due diligence until term sheet is signed.

Due diligence is an investigation or audit. The PE investor will want to confirm all facts and assertions, such as reviewing all information about the company structure, legal documents, financial records, internal controls, technology, market, products / services, operational processes, plus anything else deemed material.

Unless the PE firm has the expertise in-house, it would hire external consultants to assess the commercial and market prospects and the technical feasibility of the investment proposition. The PE firm may also speak with company references/stakeholders (e.g. with its suppliers, customers, and bankers) and on the individual members of the management team (e.g. the management team's previous employers). PE firm may also seek advice form external consultants on the key commercial and structural risks facing the business in addition to assessments on the company's technology base and intellectual property rights.

It is highly recommended that the entrepreneur's / business owner's advisor performs an independent mock due diligence on all areas of the company to identify areas of concern to ensure corrective actions are taken well in advance of the PE firm's due diligence.

Due diligence is equally applicable to an investigation of the PE firm by the entrepreneur the business owner or their advisor. The basic types of company due diligence on the PE firm include, but not limited to, source and availability of funds, investment track record in the region and in Ethiopia, speaking with the entrepreneurs / business owners that have already accepted investment from the PE firm.

WHAT ARE THE DIFFERENT AGREEMENTS THAT YOU MAY ENTER WITH PE FIRMS?

PE firms require certain basic agreements to be signed by the entrepreneur / business owners to consummate the investment and share ownership in your company. Typical agreements include:

Investment Agreement is contract establishing the terms of an investment. The agreement typically specifies such things as the amount of the investment and the rights of the investor. The investment agreements sets forth the parameters of the investment; for example, it includes what money the PE firm must invest and how the funds are going to be deployed.

Share Purchase Agreement ("SPA") is the definitive agreement that finalizes all terms and conditions related to the purchase and sale of the shares of a company. While the entire SPA should be reviewed, the entrepreneur / business owner should focus specifically on two sections: the purchase and sale section and the representations and warranties.

Shareholders' Agreement is a document that establishes the rights and responsibilities corresponding to specific class of shares, if any, that are used to facilitate the sale and purchase of shares in the company.

PE firms may also require side agreements for providing strategic support, financial advisory services to facilitate subsequent round funding. As an entrepreneur / business owner entering into a relationship with a PE firm, you should ascertain the costs of side agreements and be convinced on what you are signing to ensure that you continue to comply to the terms of these agreements.

WHY SHOULD YOU RETAIN THE SERVICES OF PROFESSIONAL ADVISORS?

The primary role of a financial advisor is to provide corporate finance advice to your business and co-owners. Your financial advisor will provide you with an impartial financial advice, independent of the private equity firm and its own advisers. The precise nature of the role varies from situation to situation but typically includes:

1. Undertaking an initial appraisal of your financing proposition.
2. Advice on your business plan – critically reviewing and appraising your plan to ensure that it includes essential areas to be included in the business and is framed and presented in accordance with the requirements of the PE firms.

3. Advice on valuation of the business and planning for the ultimate sale of the business and the realization of yours and the PE firm's investment.
4. Undertaking financial modeling – carrying out sensitivity analysis on the financial projections to establish that the forecasts make accounting and commercial sense. Checking that they have been prepared in accordance with reasonable accounting policies and with due regard to available information.
5. Advice on the most appropriate capital structure to be used to fund your proposal.
6. Making introductions to appropriate PE firms with investment criteria that match your business proposition and a business style that should be right for you.
7. Making introductions to appropriate sources of debt and other finance to help to fund your proposal.
8. Reviewing offers of finance – reviewing the terms of the deal offered by the PE firms and other finance providers (e.g. banks and leasing companies) and assisting in negotiating the most advantageous terms from those on offer.
9. Assisting in negotiating the terms of the deal with the private equity firms and banks.
10. Project managing the transaction to minimize calls on management and owners time thereby reducing disruption to the business.

The role of transaction lawyer is to review the term sheet from the private equity firm and, together with your financial advisor, will help you to negotiate acceptable terms. Your transaction lawyer will also, in due course, negotiate the investment agreements with the private equity firm's lawyer as well as negotiating any loan documents with the banker's lawyer.

WHAT HAPPENS POST PE INVESTMENT AND HOW DO YOU MANAGE RELATIONSHIPS?

The PE firm will expect to:

- Receive copies of your management accounts, promptly after each month end.
- Receive copies of the minutes of the board of directors' meetings.
- Be consulted and involved in, and sometimes have the right to veto any important decisions affecting the company's business. This will include major capital purchases, changes in strategic direction, business acquisitions and disposals, appointment of directors and auditors, obtaining additional borrowings, etc.

Here are some practical tips for a successful working relationship with your PE firm:

1. Formalize your relationship by holding meetings; such as, board meetings, shareholders meetings and document minutes of meetings, which include agenda, discussion and resolutions. Ensure to establish and work within strong governance guidelines.
2. Work in a true partnership with your PE firm: share your issues and views as often as possible. If possible, document your communications at all times.
3. Be completely transparent; disclose all news, including bad news! Don't hide things from your investor. The PE firm will find out anyway and hates surprises!
4. Listen carefully to the PE firm's advice and validate it; PE firms are savvy investors and have typically seen many cases of developing and growing companies. They can help you in identifying issues ahead of time.

5. Hire the right talent at the right time for your company together with your PE firm. Never compromise on the quality of management. Remember the PE firm invested in your team.
6. Be open to advice from your PE firm to bringing in outside expertise where necessary. Also be vigilant about the costs of outside expertise as they can be too expensive and do engage your PE firm in an objective assessment of the costs and benefits of outside expertise.
7. Have a clear plan about how to achieve sustainable earnings growth in the medium to longer-term – don't just focus on short-term targets.
8. Demonstrate a strong focus on cash management to your PE firm and actively restrain cash spend.
9. Make sure you prepare, share on a timely basis the monthly and quarterly management accounts (interim financial reports) and be ready to discuss.
10. Remember that the aim is to achieve maximum long-term value not only for your own reward (and the private equity firm's) but also with an ultimate purchaser in mind, which essentially could be an exit for both the PE firm and yourself.

HOW DO YOU PREPARE FOR EXIT BOTH FOR PE FIRM AND YOURSELF?

PE firms usually require and include in the agreements for an exit route in order to realize a return on their investments. The time frame from investment to exit can be as little as three years or as much as seven or more years. Prepare your exit strategy early enough in order to create maximum value for shareholders. As part of performance measurement and evaluation system, continue to actively evaluate exit options.

The most common exit option PE firms are looking at in Ethiopia consists of the realization of profits and cash flows over the investment period that would allow a re-purchase of their investment at an agreed upon multiples by the entrepreneur or business owners.

Other forms of exit may have been envisaged and incorporated within the investment and shareholders agreements.

Accepting PE investment in mature companies is essentially a partial exit for the business owners and shareholders. Once you have an external investor on board, it means you have started the process of eventually selling your business. Similar processes that we suggest in this guideline apply when you eventually exit the business.

Do work with your advisors on scenario planning to assess if the financial projections are sound and allow a realistic exit scenario for both the PE firm and yourself.