

Venture Capital & Private Equity Investment Models Compared



Venture Capital & Private Equity - Investment Models Compared

| | Venture Capital | Private Equity |
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| Who are the investors? | <ul style="list-style-type: none"> ■ Pension funds ■ Insurance companies ■ Family offices ■ Sovereign wealth funds ■ Endowment funds | <ul style="list-style-type: none"> ■ Same as for venture capital. |
| Investment vehicle | <ul style="list-style-type: none"> ■ Investors come together as limited partners in a limited partnership ("LP"), with the managers as directors, members and/or employees of a company or an LLP that contracts and makes investment decisions on behalf of the LP. | <ul style="list-style-type: none"> ■ Same as for venture capital. |
| Target companies | <ul style="list-style-type: none"> ■ VC funds look to invest in early-stage or start-up companies with the potential for significant growth, commonly where revenues are not sufficient to support working capital needs for planned growth. By investing their money at an early stage, where the operating company's valuation is relatively low, VC funds hope that their investment will grow rapidly and deliver a large gain on the ultimate exit. ■ As a result, most VC investments are made in the technology or life sciences sectors. | <ul style="list-style-type: none"> ■ Traditionally, the PE business model has relied on the availability of large amounts of debt – greater leverage means a smaller proportion of own money is needed to acquire the operating target, and the ultimate returns to the PE fund will also be enhanced. ■ A PE-backed company must have sufficient cash flows to be able to support high levels of leverage. Therefore, PE funds have almost always looked to invest only in mature operating companies with a solid trading history, regular cash flows and sufficient assets to persuade a bank to lend. ■ To date, there has generally been minimal focus among the PE funds on the technology or life science industries. ■ However, there are technology companies already generating good revenues that still offer room for significant growth. They may offer the potential for generating returns that may not be available from traditional PE industry sectors in light of current limitations on the availability of debt. |
| Transaction structure | <ul style="list-style-type: none"> ■ The VC fund invests directly in the target company. ■ The transaction is a cash subscription for preferred ordinary shares. The founders of an early-stage company will typically hold ordinary shares in the company. It is unusual to have any form of tiered holding company investment structure. ■ As the company will not usually be generating sufficient revenues to support working capital needs, a VC investment is likely to be one of a series of "funding rounds" to take the company through to exit. ■ Although there will usually be significant overlap in the investors at each funding round, the investors and the relative size of their investments may vary, with the result that an investor's percentage shareholding in a company may be diluted (or may increase) over time. ■ Debt is not a common feature of VC transactions. | <ul style="list-style-type: none"> ■ On a buy-out, the PE fund will actually be acquiring the target company. ■ At the same time as negotiating the investment documentation, the PE fund will also be negotiating acquisition documentation with the seller(s) of the target company. ■ A PE fund will set up a two or three tier structure of new companies to be funded by debt and equity. The bottom company within either of these structures will be used to acquire the target company. ■ Senior/mezzanine debt (bank debt) is lent usually in the form of term loan agreements. The relevant financial institutions would usually request a full security package over the assets of the target. ■ The PE fund would usually make the majority of its investment through loan notes, which will be subordinated to the bank debt.¹ ■ Equity will be in the new holding company and the PE fund would usually take ordinary shares alongside the management team. ■ A PE fund investing expansion capital into a VC-backed company is likely to be doing so with the prospect of an exit in the short or medium term. However, depending on how close the target company is to generating profits, PE funds will need to be aware that they may be required to commit additional capital to avoid dilution of their percentage shareholding. |
| Level of control | <ul style="list-style-type: none"> ■ VC transactions will usually be structured so that the founders of the business retain, initially at least, a significant (sometimes the majority) shareholding. | <ul style="list-style-type: none"> ■ A PE fund acquiring an operating company will almost always require a majority shareholding stake in that company, so that it has shareholder control. ■ A PE fund will often require "swamping rights", so that it can act quickly in certain default event situations (such as breach of financial covenants or warranties, any insolvency event or any failure to pay to the fund any preferential fixed dividend or loan note interest) to take control and remedy the relevant problem. |
| <p>In practice, despite the difference in the percentage of the target company held by VC and PE funds, the level of control is not that different as both PE and VC funds will typically have the benefit of veto rights over any material decisions by the target company or its management.</p> | | |

¹ Sometimes rather than subscribe for loan notes, PE funds may invest in the company by way of a subscription for preference shares. For the purposes of this note, however, it is assumed that a typical structure will involve loan notes.

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| Return of capital (on a liquidation, asset or share sale) | <p>Preferred ordinary shares (held by VC fund)</p> <ul style="list-style-type: none"> ■ Priority over all other shares up to an amount equal to the liquidation preference (typically 1x the amount invested) together with any arrears of dividend. Pro rata participation alongside ordinary shares in the balance of the assets. ■ An IPO may be treated in the same way as a sale. If so, the VC would usually receive a bonus issue of ordinary shares such that the proportion of the total issued share capital that it holds on IPO is equal to the proportion of the sale proceeds that the VC would have been entitled to receive on a sale on the same date at the same valuation. <p>Ordinary shares (held by founders / management and some early stage investors)</p> <ul style="list-style-type: none"> ■ Pro rata participation alongside the preferred ordinary shares after payment of the liquidation preference on the preferred ordinary shares. | <p>Senior / mezzanine debt</p> <ul style="list-style-type: none"> ■ All amounts due are repaid in priority to all shares and the loan notes. <p>Loan notes (held by PE fund)</p> <ul style="list-style-type: none"> ■ Loan notes are then repaid in priority to all shares up to an amount equal to the principal amount and any arrears of interest. <p>Ordinary shares (held by PE fund and management)</p> <ul style="list-style-type: none"> ■ Pro rata participation amongst all holders of ordinary shares after payment to holders of loan notes. |
| Dividends | <p>Preferred ordinary shares</p> <ul style="list-style-type: none"> ■ Right to participate pro rata with all other classes of shares in any profits paid out by way of a dividend. ■ Historically, as most early stage technology and life science companies have not generated distributable profits it has been unusual to see a right to a fixed (or any other) dividend as part of the terms of a VC transaction. <p>Ordinary shares</p> <ul style="list-style-type: none"> ■ Right to participate pro rata with all other classes of shares in any profits paid out by way of a dividend. | <p>Senior / mezzanine debt</p> <ul style="list-style-type: none"> ■ Right to a paid fixed interest in priority to all other classes of shares and the loan notes. <p>Loan notes</p> <ul style="list-style-type: none"> ■ Right to a fixed interest in priority to all other classes of shares but after payment of interest on bank debt and which will typically accrue until redemption. <p>Ordinary shares</p> <ul style="list-style-type: none"> ■ Subject to repayment in full of bank debt and satisfaction of loan note interest and with the consent of the PE fund, excess profits may be distributed. |
| Redemption or repayment | <p>Preferred ordinary shares</p> <ul style="list-style-type: none"> ■ The issue of redeemable shares is increasingly uncommon in the UK VC market for two reasons. First, early-stage technology companies are unlikely in most cases to have sufficient profits to be able to buy back an investor's shares. Second, redeemable shares can be subject to reclassification under Financial Reporting Standard 25 of the Accounting Standards Board as a financial liability of the company and this can have a negative impact from a presentational point of view in the context of a subsequent exit or funding round and also in the company's ordinary course business dealings with its customers and suppliers. ■ For the same reasons, the right to a fixed dividend is a less common feature of VC transactions than PE transactions. <p>Ordinary shares</p> <ul style="list-style-type: none"> ■ Not redeemable. | <p>Senior / mezzanine debt</p> <ul style="list-style-type: none"> ■ Bank debt is repaid in priority to all other equity and debt. Priority of payment is generally dealt with in an intercreditor deed, which the senior debt provider will require all relevant parties to enter into. <p>Loan notes</p> <ul style="list-style-type: none"> ■ Subject to repayment of bank debt, loan notes are ordinarily repaid in the event of a sale or listing, on a predetermined date or earlier at the option of the company (usually with the prior consent of the PE fund). <p>Ordinary shares</p> <ul style="list-style-type: none"> ■ Not redeemable. |
| Anti-dilution protection | <ul style="list-style-type: none"> ■ The preferred ordinary shares will usually carry narrow-based or broad-based weighted average (or, more rarely, full ratchet) anti-dilution protection. | <ul style="list-style-type: none"> ■ None. |
| Management incentives | <ul style="list-style-type: none"> ■ In addition to any founder shares held by them, the managers of a VC-backed company are usually issued options under a tax-efficient EMI employee share option scheme. A PE-backed target company is currently unlikely to be able to set up an EMI option scheme because it will usually be more than 50% owned by the PE fund. ■ It has become increasingly common for VC-backed companies to issue "hurdle shares" to its managers. These are shares that carry a right to participate in the proceeds of a sale above a certain threshold valuation and are most commonly used where the company is not permitted to operate an EMI scheme or where individual managers have reached the limit on the value of EMI options they are permitted to hold under the EMI legislation. | <ul style="list-style-type: none"> ■ It is commonly the case that an equity "ratchet" will be incorporated into the investment arrangements on a PE transaction, which will be designed to result in the percentage of the buy-out company's equity represented by the managers' shares varying according to the relevant PE fund's rate of return on an exit. ■ Although less common in PE transactions, the target company may issue "performance" shares to the managers, linked to performance of the company (or the group) over a fixed period of time. If the performance targets are met during that period the managers will receive the full value of those shares. At the same time, the managers will be entitled to dividends on those shares, which in practice will be rolled up and paid out when the shares vest. ■ In addition, in certain instances a "pool" of authorised but unissued shares may be set aside on completion of the relevant buy-out. This would usually be made available for incoming members of the management team (perhaps including non-executive directors appointed after completion) and/or for lower-tier employees. |

Our venture capital and private equity teams

Venture Capital

As one of the leading firms acting on venture capital transactions in the UK, Taylor Wessing is involved in matters ranging from early-stage investments, subsequent funding rounds, convertible debt and interim fundings, through to trade sales and IPOs.

Besides our in-depth experience of structuring the corporate and tax law aspects of venture capital transactions, we bring our intellectual property expertise to bear as a key component of our advice on investments in the information technology, biotechnology, materials, hardware, telecoms and other IP-rich sectors.

We advise a wide range of institutional investors, founders and companies seeking funding, and focus mainly on technology and life sciences companies.

Private Equity

Our private equity team is considered a leader in leveraged private equity transactions and we are renowned for the combined strength of our M&A expertise in the UK, Europe and in Dubai.

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We are now one of only a handful of firms operating in the mid-market with a truly integrated pan-European leveraged buy-out team.

We have trebled the number of private equity houses we act for in the last two years and, in the UK alone, now have regular workflow from 19 private equity funds.

Our venture capital and private equity teams in the UK comprise more than 30 lawyers including 10 partners.



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