



The Private Company Financial Data Authority

Private Company

KNOWLEDGE BANK

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Private Company Knowledge Bank

Version 1.0

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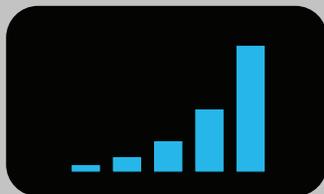
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PrivCo is the premier source for business and financial research on major privately-held companies (MPCs).

There are over 150,000 firms in the U.S. that generate over \$10 million in annual revenues yet traditional business media focuses almost exclusively on the same 15,000 publicly traded companies.

By combining the very best financial analysts, editorial quality review, market research, and our proprietary data technology, PrivCo is dedicated to producing intelligent, in-depth business and financial research on the other 90% of major corporations.

PRIVCO MEDIA, LLC

19 W 21st Street, Suite 1105
New York, NY 10010
www.privco.com

SALES/LICENSING

T: 212-645-1686
F: 646-304-1193
sales@privco.com

Introduction to Private Companies

Among the +150,000 firms operating in the United States that generate over \$10 million in annual revenues, roughly 90% are privately-held companies.

Since private companies are not regulated by the federal government and thus, in most cases¹, are not required to regularly file with the Securities and Exchange Commission, private company financial data can be incredibly elusive. At the risk of sounding promotional, this very fact is why PrivCo was founded, in order to shine a light on either large or fast-growing private companies, their financials, owners, deal history, and so on.

More so, with the burdens of the Sarbanes-Oxley Act, which imposed strenuous new accounting control and disclosure requirements (and thus significantly more cost), the benefits of staying or going private are increasingly outweighing the traditional benefits of being public for many firms.

The Benefits of Being a Publicly-traded Company

Access to Capital

One of the main advantages that public companies have is that fundraising is significantly easier for a public company than for a privately-held firm. A public company can merely file to issue new shares and then sell them on the stock market. A private company must go through an often long venture capital, bank loan, or other funding process. A public stock offering also increases a company's net worth and decreases its debt-to-equity ratio. This will often enable the company to increase its borrowings and obtain more favorable terms in future public offerings.

Better Suited for Mergers & Acquisitions

On the buy-side, publicly traded stock has the advantage of using the market's valuation and can more easily be used to acquire other companies, thus preserving the firm's cash position in the event of an acquisition. Public companies are also better positioned to finance an M&A deal due to their ability to tap public markets and more easily raise capital.

Shareholder Liquidity

Publicly-held companies enable their shareholders to sell their stock. Therefore, equity participation devices such as management and employee stock options have more value at a public company and thus can be more useful in attracting and retaining talent. Even if public stockholders do not exercise their right to sell, publicly-traded stock can be used as collateral to secure loans. Although the Sarbanes-Oxley Act of 2002 led to the emergence of numerous private secondary markets, participation is limited only to institutional or accredited investors.

Absence of an Illiquidity Discount

Depending on a private company's industry, location, and transparency, illiquidity discounts may cascade up to a proposed 20-30%. One of the main drivers of the private firm "illiquidity discount" is the difficulty involved in cash flow estimation due to the less complete accounting than that found with a public firm. Private firms are more likely to mix personal-related expenses with corporate spending and thus, upon a sale, the financials must often be re-aligned to

account for a proper bottom line and proper fair value. All else being equal, a public company enjoys a higher valuation than a similar private company because of its liquidity.

Further, public companies generally have a decentralized or less concentrated equity ownership. Due to the greater dispersion of stock ownership, the threat of a hostile takeover may be less likely than for many private companies.

Advantage in Making Acquisitions

The fact that a public company has a readily accessible share market price gives it an advantage in proposing a merger with a target company. Moreover, in a stock-for-stock acquisition, where the target company receives some or all of the purchase price in the buyer's stock, a target seller would much rather receive the liquid currency of public stock versus illiquid private buyer's stock.

Branding & Prestige

An initial public offering is a high visibility mark of success and prestige and public companies are more likely to receive attention from the media.

The Benefits of Being a Privately-held Company

Control

Without the reporting requirements, shareholder expectations, and market pressures of a public company, private firms are afforded a greater operational flexibility by being able to focus on long term growth rather than quarterly earnings. In addition, private company executives may steer their ships without shareholder approval, allowing them to take significant action without haste.

Exemption from Reporting and Investor Relations Requirements

Regulatory filings with the Securities and Exchange Commission and other post-offering duties such as shareholder discussions, research analyst discussions, and investor conferences that are necessary to comply with federal securities laws can be expensive, time consuming, and their total effects on company productivity are difficult to predict. The SEC has stringent ongoing filing and disclosure requirements, including filing quarterly reports (10-Qs), annual reports (10-Ks), and other requirements. These can add several million dollars per year alone in accounting and legal costs.

No Up-Front Cost of Going Public

Aside from the ongoing regulatory costs of being public, prior to an initial public offering, many private companies may be required to undergo significant restructuring and implement new accounting and legal controls. This process is devised to prevent any potential issues that may arise in SEC registration and may entail reorganizing the firm's organizational structure, capital structure, accounting practices, employment agreements, equity participation devices, material contracts, etc. They also must prepare a very detailed disclosure document for potential investors known as an S-1 (the IPO Filing), which easily costs millions of dollars in legal and accounting costs to prepare, not to mention management time and attention.

Non-Disclosure of Competitively Sensitive Information

By not being required to disclose details about their operations and financial outlook, private companies are not forced to disclose information that may potentially be valuable to competitors and can avoid the immediate erosion of customer and stakeholder confidence in the event of financial duress.

Hostile Takeover Risk

A private company has little risk that it will be subject to a takeover against its will. Public companies are exposed to hostile takeover attempts through tender offers (open offer of a high price to shareholders to “tender” their shares) and suddenly find themselves sold essentially against their will.

Sarbanes-Oxley Act of 2002

Sarbanes-Oxley is comprised of 11 titles that describe specific mandates and requirements for public company financial reporting. The impact of Sarbanes-Oxley is largely disproportionate to small-cap and, to a lesser extent, mid-cap public companies as the total costs for compliance are relatively similar regardless of company size. This unbalance is reflected in the IPO market as a general increase in the size of IPO filers.

Since Sarbanes-Oxley only pertains to public companies, private firms (aside from those that issue registered public debt) are exempt from the compliance requirements and thus save a great deal of time, money, and headaches. Sarbanes-Oxley is also known as the “Public Company Accounting Reform and Investor Protection Act” in the Senate, “Corporate and Auditing Accountability and Responsibility Act” in the House, and “Sarbox” or “SOX” for short.

Potential to Eliminate Double Taxation

S Corporations and Limited Liability Companies are exempt from double taxation on corporate income by requiring shareholders to report the flow-through of income and losses on their personal tax returns, thus being assessed tax at their own individual income tax rates. Due to restrictions on the number of shareholders, stock classes, and allowable shareholders, public companies are not able to structure as an S Corp. or LLC.

Risks of high opening day trading prices

In the event of an initial public offering, there is a risk of opening day trading prices being too high. If the difference between the closing price on the first day of trading and the offer price, multiplied by the number of outstanding shares, is significant investors who bought in on the deal may have a hard time adding to their positions and the company may have left money on the table. A high opening day trading price also runs the risk of the company’s stock dropping in the future and trading underwater.

Shareholder Activism

It’s not terribly uncommon for a financial institution or hedge fund to purchase more than a 5% stake in a public firm. By gaining a major stake, shareholders may influence the firm’s sale or a significant restructuring. Private firms are not prone to this potential risk.

Types of Private Companies

The following types of Private Companies fall within PrivCo's scope of coverage:

Family Owned Private Companies

Many of the United States's largest private companies have been family owned and operated for generations. Such private companies include NASCAR, Mars, and the Charmer-Sunbelt Group.

Private with a Filed, Pending, Postponed, or Withdrawn IPO

Private companies that file for an initial public offering must go through an expensive house cleaning process in order to meet the stringent guidelines set by the SEC to become a publicly traded company. Private companies with a pending IPO status are required to file quarterly updates with the SEC until further notice. Due to the strict accounting structure and high reporting costs associated with going public, many companies end up withdrawing their IPO filing.

Private Companies that were formerly Public

Due to the weighing costs of being a publicly-traded company, many firms go private or are taken private. The Private-Formerly Public category generally consists of private companies that went private through one of two avenues:

1. Bankruptcy/Restructuring - In some cases, a company will delist from a stock exchange and file with the SEC to cease reporting as part of a restructuring plan or pre-packaged Chapter 11 Bankruptcy.
2. Buyout - Leveraged buyouts are a popular form of investment in the private sector. Typically, a consortium of investors led by a private equity firm will purchase a majority stake in a public company, part in cash and part with a considerable amount of debt. This leveraged capital structure limits initial profitability as the majority of cash flow goes to servicing the debt incurred via the acquisition.

Private Companies with Public Debt

Private companies that have issued public debt to finance operations or acquisitions are required to file with the SEC and disclose financial data to investors. Disclosure is necessary to properly assess the credit quality of the private company during debt issuance.

Private Companies with Public Subsidiaries

Private companies that have a majority stake in a public company can consider the company as a subsidiary. For example, Cargill, the major agribusiness conglomerate, owns a majority stake in Mosaic Co., a publicly traded company.

Venture Backed Private Companies

Start-up private companies often require initial financing to maintain operations and focus on expansion. Venture capitalists search for opportunities to invest in private companies in high-growth industries with a goal to realize a profit on their investment upon exit. The Venture-Backed category of private companies includes some of the most popular internet and technology companies within PrivCo's coverage and include firms such as Facebook and Twitter. Please refer to PrivCo's Knowledge Bank chapter on Venture Capital for more information regarding valuation and funding stages.

Private Company Valuation

Overview

Valuation is a process used to determine what a business is worth. Determining a private company's worth and knowing what drives its value is a prerequisite for deciding on the appropriate price to pay or receive in an acquisition, merger transaction, corporate restructuring, sale of securities, and other taxable events. Private companies may include small family-owned enterprises, divisions/subsidiaries of larger private companies, or large corporations.

Many of the same techniques used to value public companies can be used to value private companies as well. Nevertheless, finding the true intrinsic value of a private company is a tricky task. It entails a set of calculations and assumptions based on industry-wide and company specific statistics. It includes key planning, adjusting of financial statements and applying the appropriate business valuation methodology. Unfortunately, there are several factors that influence the valuation, which include size, lack of operational history, management and operational control, difficulty quantifying earnings and cash flow, capital structure, and risk in the business.

Of the numerous acceptable valuation methods, each will yield a different result based on the sensitivity of inputs. In addition, there are certain modifications necessary to adjust for the private status of the private company. The cost of capital for private companies is different since they do not have access to capital via equity markets. The key to establishing a starting point for any private company valuation is to determine the type of the company involved, whether its private or a publicly traded company, and its appropriate industry.

Private Company Valuation Techniques

Though often smaller in size and less financially transparent than their publicly traded peers, private companies have a major importance in the world's economy. Among the 150,000+ firms operating in United States that generate greater than \$10 million in annual revenues, roughly 90% are privately-held companies. A privately-held company is owned either by non-governmental organizations or by less than 300 shareholders so as not to require reporting with the Securities and Exchanges Commission. The private company's owners do not publicly issue or trade shares of the private company, instead they keep ownership and associated transactions discreet.

Valuation of such closely-held private companies can be expensive and difficult due lack of exact financial information. Although it may be difficult to research private companies, it is not impossible. There are methodologies and financial tools available to assist in making reasonable estimates of a private company's value. With an estimated value and a good intuition, one can arrive at a reasonable range of a private company's intrinsic value.



Factors Influencing Private Company Valuation

Private company valuation is not an entirely objective matter. Subjective estimates, influenced by motivations and incentives, may alter valuation outcomes. One might need to value a private company for the following reasons:

- To sell it
- To raise capital from investors
- As part of a divorce settlement
- For a management buyout
- For estate planning
- For an employee stock ownership plan (ESOP)
- For taxation purposes

Other factors that influence a private company's valuation are its size, lack of operating history, management and operational controls, difficulty in quantifying earnings and cash flow, capital structure, risk in business and breadth of liquidity in the market for private company's stock.

1. Lack of Market Liquidity

The lack of liquidity discounts the value of a private company by as much as 50% since there is no benchmark for valuing private companies on a daily basis as with a publicly traded exchange. Most commonly, a liquidity discount of 20-30% is applied. There are many factors that go into determining the discount factor in a private valuation including size, operating history, quality of earnings/cash flows, management, industry profile, and business risks.

2. Size

Privately-held companies are generally much smaller than publicly-traded comparables. Small private companies may be good acquisition targets for larger competitors and publicly-traded counterparts.

Size contributes to the discount of the valuation since it reflects the industry. Small industries may be not as attractive or have desirable growth rates, which could negatively influence the valuation multiple. Smaller sized businesses also have considerably more risk than larger ones.

3. Operating History

Operating history is important to determine a track record for revenue growth, profitability and earnings growth. The less operating history a private company has the greater the risk for inconsistent cash flows, which leads to a greater valuation discount.

4. Business Mix

Depending on whether a private company operates within a niche or has a variety of product mixes can impact the valuation discount. Market share and product concentration add to business risk.

5. Management Control

Private companies have a very small pool of shareholders that often act as managers. This limits the pool of talent that runs the private company. In addition there may be no succession plan placing the business in considerable risk if the principal manager is no longer able to work. Finally, family controlled

enterprises may have considerable internal conflict over the operational control. These risks lead to increased valuation discount.

6. Earnings Measurement

Although public companies are managed to maximize earnings on a quarterly basis, private companies may be managed for tax minimization, long term growth, or cash flow. Different operational motives make it difficult to measure true earnings and cash flows of the private company. It is important to normalize financials when trying to value a private company to determine what the private company would be earning if it was operated like a public company.

7. Capital Structure

Private companies, unlike public companies, do not have as broad of an access to capital and therefore are unable to be as selective of their funding sources. Public companies are able to choose from both equity and debt sources to minimize their cost of capital while private companies are primarily dependent on bank loans, which are relatively expensive and weaken the balance sheet, or internal cash flows.

8. Risk

Private companies are generally riskier than their public comparables. Lack of size, financial track record, expansive industry, or business concentration risk.

Valuation of Private vs. Public Companies

Private company valuations are discounted based on several risk factors associated with private sector investing, which results in a marked difference between the valuation of a privately held company, subsidiary or a division and a publicly traded corporation. There are number of distinctions between private and public companies that have an impact on the private company's value. An accurate valuation of privately owned companies largely depends on availability and reliability of the private company's historic financial information. Public company financial statements are officially audited, documented and overseen by a government regulator. Alternatively, private firms do not have government oversight unless operating in a regulated industry and usually audited financial statements are not required.

Moreover, private companies may manage their operations for different purposes than profit. Managers of private firms often prepare their financial statements to minimize profits and, therefore, taxes. Alternatively, managers of public firms tend to want higher profits to increase their stock price. As a result, a firm's historic financial information may not be accurate and can lead to over- and undervaluation. In an acquisition, a buyer often performs due diligence to verify the seller's information. When analysts put a value on a particular private company, privately held companies are often valued lower than their public counterparts. The lower value is attributed to the fact that there is no liquid market for the private company's stock. Such discounts are accounted for during valuation.

Private Company Valuation Methodologies

Since private companies may manage their balance sheets and earnings for alternative purposes, discounted cash flow analysis or comparable valuation techniques require additional research. Earnings and capital structure might need to be reorganized or modified accordingly. When it comes to private companies, some nontraditional valuation techniques may be appropriate such as analysis of invested capital, replacement cost, asset appraisal and capitalization of earnings.

As discussed earlier, there are several methods for estimating the value of a particular private company. When it comes to private companies, the following three techniques are most commonly used:

- 1. Comparable Company Trading Multiple Analysis (also known as "peer group analysis", "equity comps", "trading comps", "public comps", or "public market multiples")**
- 2. Precedent/Comparable Transaction Analysis (also known as "transaction comps", "deal comps", or "private market multiples")**
- 3. Discounted Cash Flow ("DCF") Analysis**

Other Valuation Methodologies include:

- 1. Break-up Analysis**
- 2. Asset Valuation**
- 3. Analysis of Invested Capital/Replacement Cost**
- 4. Leveraged Buyout (LBO) Analysis**

Comparable Private Company Trading Multiple Analysis (Public Comps)

Comparable company trading multiples analysis or trading comps uses the valuation multiples of similar or comparable publicly-traded companies to value a target private company. Peers can be grouped based on any number of criteria, such as industry focus, private company size, or growth. The multiples can be Enterprise Value (EV) based multiples like EV/Sales, EV/EBITDA or EV/EBIT, and Equity based multiples like Price to Earnings (P/E). The multiples derived from this type of analysis are at a given point in time and generally change over time. It is important to note that trading multiples do not reflect control premiums or potential synergies. Generally, the following steps are applied to compare your target private company to a similar public company:

1. Compile and select the list of comparable private companies

To select the comparable universe or peer group for a given target private company, one must understand the target private company's business to ensure that its peers share similar industry, business, and financial characteristics with the target. Among the few suitable sources that can provide insight in identifying accurate public comparables are annual reports or 10-K (especially the section on competition), the public companies' prospectus, SIC code lookup, and PrivCo's private company reports.

Once you have identified the comparable universe, the next step is to gather all necessary information for each peer company, usually from 10-K, 10-Q, and/or 8-K earnings press release, consensus financial projections or a recent analyst research report with financial projections.

2. Calculate relevant financial and multiples

Making pro forma adjustments to a comparable company's financial statements is often the trickiest part. It requires normalizing the financials to adjust for one-time / non-recurring items that temporarily distort earnings. Income statement items (denominator) should be adjusted for one-time or non-recurring items. For the valuation purposes, non-recurring items should not be included in financials (e.g. P&L statements, EBIT, EBITDA, Net income, etc).

After selecting a universe of comparable companies, create a list of ratios and values you want to compare. These can include price, shares outstanding or market capitalization, earnings per share (EPS), growth rate (five-year), price-to-earnings ratio (P/E), price-to-sales ratio (P/S), EV (enterprise value), EBITDA (earnings before interest taxes, depreciation and amortization), etc.

Next step is to calculate multiples. Multiples are the heart of the comparable companies analysis as it is hinged on both the comparable company's risk profile and operating performance. Multiples that are used should be relative to the industry and appropriate in relating the public and private companies.

Equity Multiples: Certain flows apply to equity holders only, like net income & book value of equity. The balance sheet and income statement values utilized are after discretionary debt payments. Hence, equity multiples are used to derive an implied equity value. Relevant multiples:

- Price/Earnings (market equity value / net income to common shareholders)
- Price/Book (market equity value / book value of equity)
- Price/Cash Flow (market equity value / after-tax cash flow)
- PEG Ratio - measures growth prospects (PE Ratio / Annual EPS Growth)

Enterprise multiples: Other flows apply to all capital providers (debt & equity). The balance sheet and income statement values utilized are before the effects of discretionary debt payments. Hence, enterprise multiples are used to derive an implied enterprise value. Relevant multiples:

- Enterprise value/Sales
- Enterprise value/EBITDA
- Enterprise value/EBIT

It is best to compare several multiples during the analysis to determine which one(s) the market uses to value the universe of comparable private companies.

3. Apply valuation and analyze the results

Finally after calculating relevant multiples, one must determine implied valuation ranges. To compare comparable private companies effectively, one must understand why their multiples are different. Reasons why one private company's projected EV/EBITDA multiple might be lower than that of a peer could include slower projected growth, declining margins, or a higher risk profile. For example, performing a comparable company analysis is an art, not a science. It's important to pay careful attention to the selection of comps, how one spreads the financial for each private company, and selection of favorable multiples.

4. Apply a private company discount, if applicable

It is not merely enough to simply use the same multiple as that of another publicly traded private company. In most, if not all cases, the multiples that the “comps” universe is trading at must be subjectively adjusted as public companies will typically receive higher valuations than their privately held peers due to a lack of liquidity and the potential restructuring or accounting reorganization challenges that may arise in the event of an exit. Valuation discounts for liquidity should be applied to the private company that best reflects the target private company’s risk and often ranges from 20-30%.

A major disadvantage of this valuation method is that it is often difficult to determine the right comparable private companies. Very rarely does one find two identical private companies. Hence, adjustments should be made to reflect differences, such as business mix, geographic spread and capital structure.

Comparable Transaction Analysis (Deal Comps)

Comparable transactions analysis or analysis of selected acquisitions is very similar to trading comps except deal comps utilize actual transaction multiples instead of trading multiples from the universe of comparable private companies. The analysis uses multiples and premiums paid in comparable transactions to value target private companies. When using this approach to value private companies, transactions should have relevant attributes:

- Industry group
- Timing - Transactions should be recent (typically no more than five years)
- Business mix (products, markets served, distribution channels, etc)
- Geographic location
- Size (revenues, assets, market cap)

The process of compiling deal comps is similar to assembling trading comps, but data can be more difficult to locate. Sources of information for public deals include internal firm resources, press releases, SIC/NAICS code screen, 8-K’s, Proxy’s and other SEC filings.

The major disadvantage of this method is the only commonly available metric is sales, and value is not always clearly tied to sales or even profit. Moreover, precedent transactions are rarely directly comparable. Every transaction has its own set of unique circumstances and not all aspects of a transaction can be captured using valuation multiples.

Discounted Cash Flow Analysis

This method uses the forecasted free cash flow of the target private company (meeting all the liabilities) discounted by the firm’s weighted average cost of capital (the average cost of all the capital used in the business, including debt and equity), plus a risk factor measured by beta. Since risks are not always easy to determine precisely, Beta uses historic data to measure the sensitivity of the private company’s cash flow, for example, through business cycles.

KEY COMPONENTS OF A DCF

Free cash flow (FCF)	Cash generated by the assets of the business (tangible and intangible) available for distribution to all providers of capital. FCF is often referred to as unlevered free cash flow, as it represents cash flow available to all providers of capital and is not affected by the capital structure of the business.
Terminal value (TV)	Value at the end of the FCF projection period (horizon period).
Discount rate	The rate used to discount projected FCFs and terminal value to their present values.

Estimating Beta. Beta is a historical measure a stock's volatility versus the market as a whole. Since private companies do not have equity traded on any exchange, there is no concrete method for determining the beta of a private company's equity. Therefore the estimation of beta is based on the trading volatility of comparable public companies. It is important to calculate the unlevered betas of the universe of comparable private companies.

$$\beta_{\text{unlevered}} = \beta_{\text{levered}} / (1 + \text{Debt} / \text{Equity}) (1-T)$$

Following the calculation of unlevered beta, determine the optimal debt ratio for the private company by either using the existing company capital structure or taking on the industry average capital structure. It is then that you must relever the average unlevered beta for the private company using the optimal capital structure.

$$\beta_{\text{levered}} = \beta_{\text{unlevered}} / (1 + \text{Optimal Debt} / \text{Equity}) (1-T)$$

Problems with Equity Risk Premium. Equity risk premium is the return that investors seek to obtain by investing in the stock market. Equity risk premium is the difference between the risk free rate and the demanded rate of return from the stock market. The equity risk premium for private companies needs to be adjusted to reflect a higher return for a riskier investment.

Estimating Cost of Equity. The cost of equity of a private company is calculated as a function of the risk free rate, beta, and the market premium.

$$\text{Cost of Equity} = \text{RFR} + \text{Beta (MP)}$$

The risk free rate is often known as the interest rate associated with what is considered a "riskless" security (typically the yield on the highest rated government bonds in the 10-20 year maturity range).

Estimating Cost of Debt. The problem with the cost of debt of private companies is that many private companies rely on bank loans as their primary source of funding. Bank loan rates are outdated and term structures are long-term. Therefore bank debt does not reflect the current debt cost of capital and is usually offered at a premium to public debt.

Calculating the current cost of debt capital would require analysis of comparable public company cost of debt or the approximation of the cost of acquiring new funding as of the valuation date.

$$\text{After-Tax Cost of Debt} = \text{Cost of Debt} * (1 - \text{Tax Rate})$$

Estimating Cost of Capital. Percent of debt and equity is obtained from the capital structure.

$$\text{WACC} = (\text{Percent Debt}) * (\text{Cost of Debt}) + (\text{Percent of Equity}) * (\text{Cost of Equity})$$

Special Problems with Private company Cash Flows. It is important to normalize cash flows to reflect an arm's-length approach to management. Recasting cash flows for the private company is to determine the true value of the private company based on "real" cash flows.

Issues with Calculating Terminal Value. The two main ways of calculating the terminal value of a private company is through comparable multiples or perpetuity growth method. Considerations must be made in both methods that appropriate recast cash flows are used and growth rates are inline with potential growth opportunities for the private company based on management discussion and industry analysis.

Using the comparable multiples method requires that the private company's financial statements are recast to reflect the style of their public comparables. In addition, since private companies are organized under different corporate structure (LLC, LP or S-Corp), financial statements may not be a reasonable view of the private company's performance on which an earnings multiple may be used.

Final Observations on DCF Analysis

Valuing a private company using a discounted cash flow analysis requires consideration to be given to recasting financial statements to mirror public counterparts and adjusting components of the WACC to mirror current cost of capital in an illiquid market. It is important to make sure that all adjustments are reasonable and defensible.

The major disadvantage of this method is that the precision of the valuation is not always accurate. The outcome of the valuation is highly dependent on the quality of the assumptions made regarding FCF, TV, and the discount rate. As a result, DCF valuations are usually expressed as a range of values rather than a single value by using a range of values for key inputs.

OTHER VALUATION METHODS

Asset Appraisal

Asset valuation applies to companies that have heavy fixed assets, such as manufacturing plants or refineries; it is appropriate to value the assets independently from the firm. An asset appraisal will yield a more accurate valuation than a discounted cash flow analysis in private companies such as these. In this method, the fair market value of fixed assets and equipment (FMV/FA) is calculated as a means of evaluating the business.

Break-up Analysis

A break-up analysis is simply a sum of parts valuation based on different business lines. Each part is valued separately employing above methodologies and then summed together. This is very relevant for private companies with dissimilar business lines.

Internal Rate of Return

Internal Rate of Return is a valuation methodology that can be used to calculate the entry price, exit price, or average cashflows in an investment. IRR, given certain inputs such as exit price and cash flows within the investment, can be used to calculate a desired return rate, entry price, or other factors.

Given the high risk on investment in venture capital and private equity, the firms require a high IRR in their target companies. In this case, the IRR represents the percentage of profits made on an investment in a specific period of time. Technically, the internal rate of return is the discount rate that generates a zero net present value.

Ex. A firm acquires a private company for \$35 million in 2011 and exits in 2012 at \$70 million. The firm's IRR is 100% with an NPV of \$35 million.

$$(\text{Price Entered} - \text{Price Exited}) / (1 + r)^t$$

LBO Analysis

Another valuation methodology that is used is Leveraged Buyout or "LBO" analysis. Leverage is simply the use of debt; an LBO is the purchase of a private company through the use of borrowed funds, or debt. This method is used to determine the range of prices that a financial buyer would be willing to pay for a company based on target rates of return to equity (IRRs) and leveraged capital structure. Typically, the target company of an LBO analysis is public. The public equity is being bought out by a small number of investor, thus taking the private company private. In some cases, an LBO involves strong management support and participation. In such a case, management, with the help of a private equity firm, employ their own funds to take the private company private. This is also referred to as a Management Buyout.

OTHER VALUATION METHODS (continued)

Replacement Cost

Similar to the total invested capital valuation; replacement cost valuation considers the total cost of reproducing the operations of the business in today's environment. This accounts for start-up expenses, real estate, equipment, and inventory and labor costs.

Total Invested Capital

Cash generated by the assets of the business (tangible and intangible) available for distribution to all providers of capital. FCF is often referred to as unlevered free cash flow, as it represents cash flow available to all providers of capital and is not affected by the capital structure of the business.

Conclusion

How do you go about valuing a private company? It's a simple question with a complex answer. While there are numerous valuation methodologies that can be utilized to establish value, not all methodologies would be appropriate in all situations.

Among the techniques used for valuation of private companies; break – up analysis, asset valuation and DCF models are less feasible options as it requires detailed financial information from inside the private company. Since private companies manage their balance sheet and earnings for different end goals than public companies, using discounted cash flow or comparable valuation techniques require additional insight. Due to lack of liquidity and increased risk in business, the discount rates used in DCF analysis needs to be modified accordingly. Therefore a more feasible approach is to find comparable private companies whose values are known. Comparable companies analysis is mostly used in M&A advisory, fairness opinions, restructuring, IPOs & follow-on offerings, and share repurchases. Furthermore, the trade comp approach is pertinent if there are publicly traded competitors; in its absence deal comp approach is used.

Each valuation approach has its own particular use and should be used in that respect. It is doubtful that any one analysis by itself will yield a pinpoint number that can be relied upon. Rather, it is likely that one will need to use multiple approaches to yield a range of values for a private company. Each methodology provides additional clarity on the other valuations. Evaluating the results of numerous methods provides a better understanding of a business' true worth. It is also important to note that different people will have different ideas on the value of a company depending on factors such as public status of the seller and buyer, nature of potential buyers (strategic vs. financial), nature of the deal, market conditions (bull or bear market, industry specific issues) and tax position of buyer and seller. A fair amount of experience, judgment and corporate finance and equity market knowledge is required. In each case, seemingly straightforward tools contain several hidden layers of complexity and restraints.

PrivCo.com helps the private company valuation process by providing the comparable companies – both private and public – and comparable transactions needed in this process.

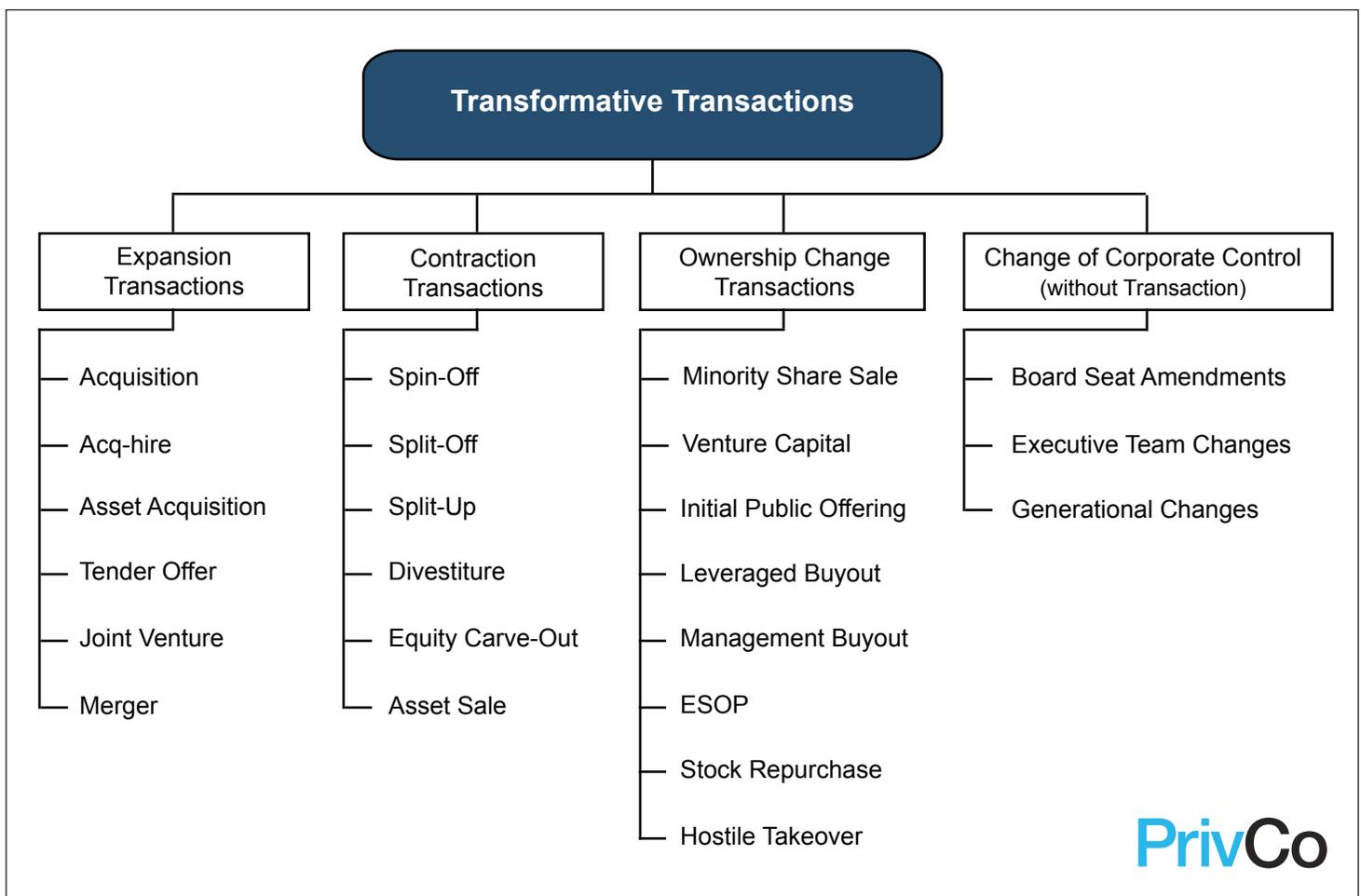
Private Company Mergers & Acquisitions

Overview

In order to adapt to competitive pressures, advancements in technology, and economic conditions, privately-held companies are often forced to adapt their business by acquiring or partnering/merging with another company in order to remain competitive or simply to grow their business. A private company may also sell itself to a larger public company for the same reasons. Private companies may reconfigure their assets, operations, and relationships with the stockholders in search of higher growth, new technology, business expansion, and greater revenues.

Mergers, acquisitions, and corporate restructurings often enable a private company to develop a competitive advantage by increasing flexibility, growth, and shareholder value. Common M&A motives include: strategic growth, talent growth (acq-hire), preparation for an IPO or exit, and to enter a new geographic or demographic market (buy vs. build).

Types of Private Company M&A and Similar Transformative Transactions



Expansion Transactions

Expansion is an increase in the size of a private company's business due to a transformative transaction. There are a variety of reasons private companies choose to expand through an expansion transaction rather than naturally ("organically"). First of all, growth happens much faster, virtually overnight in some cases, whereas natural organic growth takes time as its sales grow. A private-held company may want to eliminate a competitor, enter a new geographic market, introduce a new product line, or bring on the talent and management team that results from an expansion transaction.

Expansion can be accomplished through mergers, asset acquisitions, tender offers or joint ventures. The following methods can be used to help a private company grow without having to create a whole other business entity.

EXPANSION TRANSACTIONS

Merger

A private company merger is when two or more private companies combine to form a single entity under a consolidated management and ownership. A merger can take place through an amalgamation or absorption.

Amalgamation: An amalgamation is when two or more private companies enter into the merger agreement to form a completely new entity. In this type of merger both private companies lose their identity and a new private company is formed to manage the consolidated assets. Amalgamation tends to occur when both private companies are of equal size.

Absorption: Absorption is when the merger occurs between a two entities of dissimilar size. In such a case, the larger private company would absorb the smaller one. The fusion dissolves the smaller private company and places all its assets in control of the larger private company. Absorption may also take a smaller private company and make it a stand alone operating division or subsidiary of a larger private company.

Acquisition

A private-market acquisition is when a company (public or private) buys up the stock of a private company. An acquisition may also take the form of an "asset acquisition", where rather than buying the stock, the buyer simply buys the entirety or a portion of the assets of another private company. The assets may be tangible such as plants and machinery or intangible assets such as patents and trademarks. The target private company may then continue as a smaller company or dissolve.

EXPANSION TRANSACTIONS (continued)

“Acq-hire”

An “acq-hire” (or acquisition-by-hire) may occur especially when the target private company is quite small or is in the startup phase. In this case, the acquiring company simply hires the staff of the target private company, thereby acquiring its talent (if that is its main asset and appeal). The target private company simply dissolves and little legal issues are involved.

Tender Offer

A tender offer is an offer by an acquiring company to the general shareholders of a target private company to purchase a majority of the equity at a premium to market value. Tender offers are an attempt to gain management control through holding the majority of voting equity. Note that tender offers are less common for private companies than they are for publicly traded companies.

Joint Venture

A joint venture is when two or more private companies enter into an agreement to allot a portion of resources towards the achievement of a particular goal over a designated period of time. Synergies occur when businesses capitalize on joint opportunities or other combined efforts to obtain an effect greater than working alone, whether it is increased revenue or decreased costs.

Key Differences Between Mergers and Acquisitions

Although often very similar, mergers and acquisitions are two distinctly separate types of transactions. In the purest sense, a “merger” refers to a merger of equals: two companies of the same size come together, surrender their shares, and issue new shares for a new, combined company. In a merger, the merging organizations surrender their shares and issue new shares for a new, combined company.

A merger of equals is actually quite rare since most deals that are reported as a merger are actually acquisitions, where one firm actually purchases and assumes ownership of the other. Acquisitions are often publicized as mergers because they’re easier for the target firm and PR teams to swallow and are believed to help promote a more successful integration of the firms’ operations. In some acquisitions, the acquirer will create a Merger Sub for the transaction. A Merger Sub is a non-operating legal entity that acts as an investment vehicle for the acquirer, allowing it to merge the target with the Merger Sub entity, labeling the acquisition as a merger.

Many small private firm targets are actually acquired as an asset purchase rather than a formal acquisition. An asset purchase transaction may take place in lieu of an acquisition if the target firm’s accounting practices are not in compliance with Sarbanes-Oxley or if the acquiring firm couldn’t afford to spend the time or resources required for a full due diligence process. After the asset purchase transaction is complete, the target company will often still exist, although without active operations, in order to pay off its remaining bills before dissolution and the distribution of remaining funds to shareholders.

TYPES OF MERGERS	
Horizontal Merger	A horizontal merger is when two private companies from the same business class or market enter into a merger agreement. In a horizontal merger, the merged private companies benefit from economies of scale and increase total market share by consolidating facilities, combining operations, increasing working capital, reducing competition, or reducing advertisement costs, etc.
Vertical Merger	A vertical merger occurs when two firms from different stages of the same business class, activity or operation enter into a merger agreement. These types of private companies typically have buyer-seller or supply chain relationships before the merger. Generally, private companies attempt vertical mergers or hostile takeovers of other firms to maximize backward or forward integration along their supply chain. The acquiring private company reaps the benefits of a reduced inventory and more efficient allocation working capital.
Conglomerate Merger	A conglomerate merger is when two private companies that operate in different or unrelated business lines enter into the merger agreement. Firms choose to enter into a conglomerate merger to benefit from the access to greater financial resources. Firms, by expanding into new markets and different businesses, create a diverse portfolio of products that balance business risk.

Key Differences Between Public and Private M&A

Both Public and private companies engage in M&A transactions, but there are several key differences to note between the processes for each. These characteristic differences are expanded upon below:

PUBLIC COMPANY M&A	PRIVATE COMPANY M&A
<ul style="list-style-type: none">• Due to the high liquidity of publicly traded stock, public firms may more easily use their shares as M&A currency.	<ul style="list-style-type: none">• Although in some cases, a private company may use its stock as currency for an M&A transaction, an illiquidity discount applies. A valuation method that consists primarily of discounted cash flow and asset valuation is most likely to apply and the private firm will most often use cash to acquire a given target.
<ul style="list-style-type: none">• Can raise money from the public market to help finance an M&A transaction.	<ul style="list-style-type: none">• Cannot raise money from the public market and must resort to debt financing, venture capital, or other private forms of funding.
<ul style="list-style-type: none">• Not subject to an illiquidity discount.	<ul style="list-style-type: none">• Private firms suffer an illiquidity discount that may revolve around 20-30%.
<ul style="list-style-type: none">• Public M&A transactions must be approved by the SEC for anti-trust purposes and also require Sarbanes-Oxley compliance.	<ul style="list-style-type: none">• Sarbanes-Oxley compliance is only relevant to private companies that have future plans to go public or to be acquired by a public firm.

Strategic Vs. Financial Buyers

Potential private company buyers and investors fall into two primary categories:

1. Strategic Buyers

Strategic buyers search for operating private companies that offer products or services similar to their own. Targets of strategic buyers are often competitors, suppliers or customers of the original firm. Strategic buyers can also aim to acquire firms that have operations that are unrelated to their core businesses. Such an acquisition would be considered as an attempt of a strategic buyer to diversify their revenue sources. Their goal is to identify private companies whose products or services can synergistically integrate with their existing businesses to create long-term shareholder value.

2. Financial Buyers

Financial buyers include private equity firms (also know as “financial sponsors”), venture capital firms, hedge funds, family investment offices and ultra high net worth individuals. These firms and executives are in the business of making investments in private companies and realizing a return on their investments. Financial buyers look to identify private companies with attractive future growth opportunities and durable competitive advantages, invest capital in their operations, and realize a return on their investment upon exit via a direct sale or an IPO.

Contraction Transactions

Contraction is the reduction in the size of the private company or business due to corporate restructuring. For more information on contractual corporate restructuring please see PrivCo's section on Bankruptcy and Restructuring.

CONTRACTION TRANSACTIONS

Spin-Offs

A spin-off transaction is when a parent private company separates the shares of its subsidiary from the original private company shares and distributes those shares, on a pro-rata basis to its shareholders. In essence, two separate entities are formed in which the stockholders are issued the shares in the legal subsidiary proportional to their original holdings in the parent private company. Both the entities have their own management and run individually after the spin-off. The distribution of the subsidiary's stock to shareholders is in the form of a dividend. This is typically a tax-free transaction for both the shareholders and the parent.

Split-Offs

A split off is the separation of a subsidiary from the parent by splitting the shareholders of the parent private company's stock from the shareholders of the subsidiary's stock. Most split-offs are tax-free transactions and used to downsize a private company or defend against a hostile takeover. In a split-off a new private company is created to take over the operations of an existing unit or division and some of the parent private company's shareholders will receive the stocks in subsidiary or in new private company in exchange for the parent private company's stocks. As a result, the parent private company will be able to downsize its overall business.

Split-Ups

A split up is when an entire firm is broken up in the series of spin-offs. After a split-up the parent private company no longer exists, only the spun-off businesses of the original private company survive. In a split-up transaction, new classes of stock are created to track the operations of each of the individual subsidiaries. The new classes of shares are distributed as a dividend to current stockholders and then the parent private company is dissolved.

Divestiture

A divestiture is a direct sale of a portion of the parent private company to an outside party in return for cash. Generally a firm sells struggling operations that operate at a loss or require upkeep capital. A parent private company may also divest non-strategic or non-gaining businesses and invest the proceeds of the sale in potentially higher return opportunities or core business expansion. Divestitures may also be used to realize the true potential of an outperforming asset, whose performance is not properly valued by the market. The tax basis of the asset intended for divestiture will be considered before deciding on the appropriate type of divestiture.

CONTRACTION TRANSACTIONS (continued)

Equity Carve-Out

An Equity carve-out is a sale of a portion of equity in a subsidiary to the public via an IPO. The parent private company retains the majority stake in the subsidiary, usually greater than 80%. With ownership of over 80%, the parent private company still retains the right to undertake spin-offs and split-offs on a tax free basis. In an equity carve-out, a new legal entity is created and issues new shares, which are distributed to outside investors.

Asset Sale

An asset sale involves the sale of tangible or intangible assets of the private company to generate cash. This cash can be used to pay out a dividend, adjust capital structure, or purchase other assets or investments. In an extreme case, an asset sale may be part of a Chapter 7 liquidation plan where a private company ceases all business operations and sells all its assets. (See *PrivCo's Bankruptcy and Restructuring* section for more information on Chapter 7 liquidations.)

Ownership Change Transactions

An ownership change transaction is exactly what it sounds like: a transaction where the company's ownership changes so the firm welcomes new owners or a different composition of ownership stakes for its existing shareholders.

OWNERSHIP CHANGE TRANSACTIONS

Minority Share Sale & Venture Capital

A private company can have a change in its ownership structure if it sells some of its shares to an outside investor, such as an individual ("Angel") or venture capital firm ("VC Firm"). Note that in the case of venture capital deals, this often occurs in conjunction with a Change of Control since the VC Firm will usually demand Board seats, preferred stock and dividend rights in addition to other rights and terms.

Initial Public Offering

By going public via an Initial Public Offering (IPO), the company can change control of the company from the private owners', founders', or controlling family's hands to partially (even a majority) public investors. An IPO often has the added benefit of providing both expansion capital as well as liquidity for the company.

OWNERSHIP CHANGE TRANSACTIONS (continued)

Leveraged Buyout

A leveraged buyout is a situation in which a group of investors (usually a private equity firm – see Glossary for definition) acquire a controlling interest in a given private company's equity by borrowing a large portion of the capital necessary to finance the transaction. The acquired private company's assets are often used as collateral against the borrowed capital. In a leveraged buyout situation, a combination of debt instruments from bank and capital markets are deployed.

Leveraged buyouts use a highly leveraged capital structure where the majority of the cash flow from the acquired private company, division or subsidiary is used to service and repay the loan. Leveraged buyouts may be used to enhance shareholder value, counter takeover threats or realize the value of undervalued assets.

Employee Stock Ownership Plan (ESOP)

An employee stock option plan is the transaction where the private private company makes a tax deductible contribution of cash or stock of the company into a trust. Here the assets are allocated to employees and will not be taxed until withdrawn by them. ESOP can be used in two ways in merger and in LBO's: as a financing option for the acquisition of private companies and anti-takeover defense in LBO.

Leveraged ESOP

Although an uncommon transaction leveraged ESOPs are typically used to concentrate the ownership of a private company in the employees' hands. This is another method to defend against a possible takeover. An ESOP is an employee stock ownership plan where employees own a piece of equity in the private company. Leveraged ESOPs are initiated by borrowing capital to capture a majority of the equity at one time. This equity can then be vested over a period of time to the employees. Leveraged ESOPs drastically alter both the capital structure of a private company (by increasing the liabilities), and the ownership concentration from the original owners/management to the employees.

Share Repurchase

A share repurchase program is a measure implemented by cash-rich corporations to concentrate the ownership of the private company by purchasing equity shares at a premium to market value. Private companies can use share repurchase programs to accrete the ownership of upper level management, lever up the balance sheet and thwart the threat of a takeover. Share repurchases lead to decreased equity capital of the private company. While less rare for private companies than for publicly traded ones, many private companies that have the cash to do so can make a tender offer in order to reduce the number of shareholders and concentrate ownership and control of the company.

OWNERSHIP CHANGE TRANSACTIONS (continued)

Takeover

In recent years there has been a high level of hostile takeovers. Takeovers can be defined as acquiring control of the private company or management by stock purchase or stock exchange. The majority of takeovers have come in the form of leveraged buyouts, proxy battles, or forced internal restructuring by vocal institutional investors who aim to maximize the shareholder value of their clients. Hostile takeovers are relatively rare for private companies, but can and do occur.

Change of Corporate Control Without a Transaction

Changes in control of a private company often occur as a result of a Change of Ownership Transaction (see above) such as an M&A deal or a Venture Capital or Private Equity investment. However, change in control of a private company can also occur without an acquisition or divestiture. Corporate control is the control over the management of the firm. Management decisions influence strategy of the organization and directly impact employee tasks.

During an internal restructuring or change of control, a private company evaluates its internal process, and management team. A change of control can result from:

CHANGES OF CONTROL WITHOUT A TRANSACTION

Board Seat Changes

Since ultimately the company's Board of Directors controls the company, voluntary changes made to the private company's Board of Directors will result in a change of control without a merger, acquisition, or other transformative transaction. Changes in the private company's Board of Directors may be made for a variety of reasons: the company may need additional expertise in a certain area for example. A Director may also be forcibly removed by the private company due to the Director's conflict of interest, or the private company's accountants may force the addition or removal of a Director because the accounting firm feels the Board lacks independence from management, needs an Audit Committee or a Compensation Committee to make independent decisions regarding the firm's books and records (Audit Committee) or management's pay and compensation (Compensation Committee).

Management Changes

Via its Board, a firm may hire a new CEO, CFO or make other changes in its Executive Team, resulting in a change of control without any M&A transaction. (Note that PrivCo has a "Leadership Change" tag that enables users to search by this tag in order to target M&A or investment opportunities.)

Generational Changes

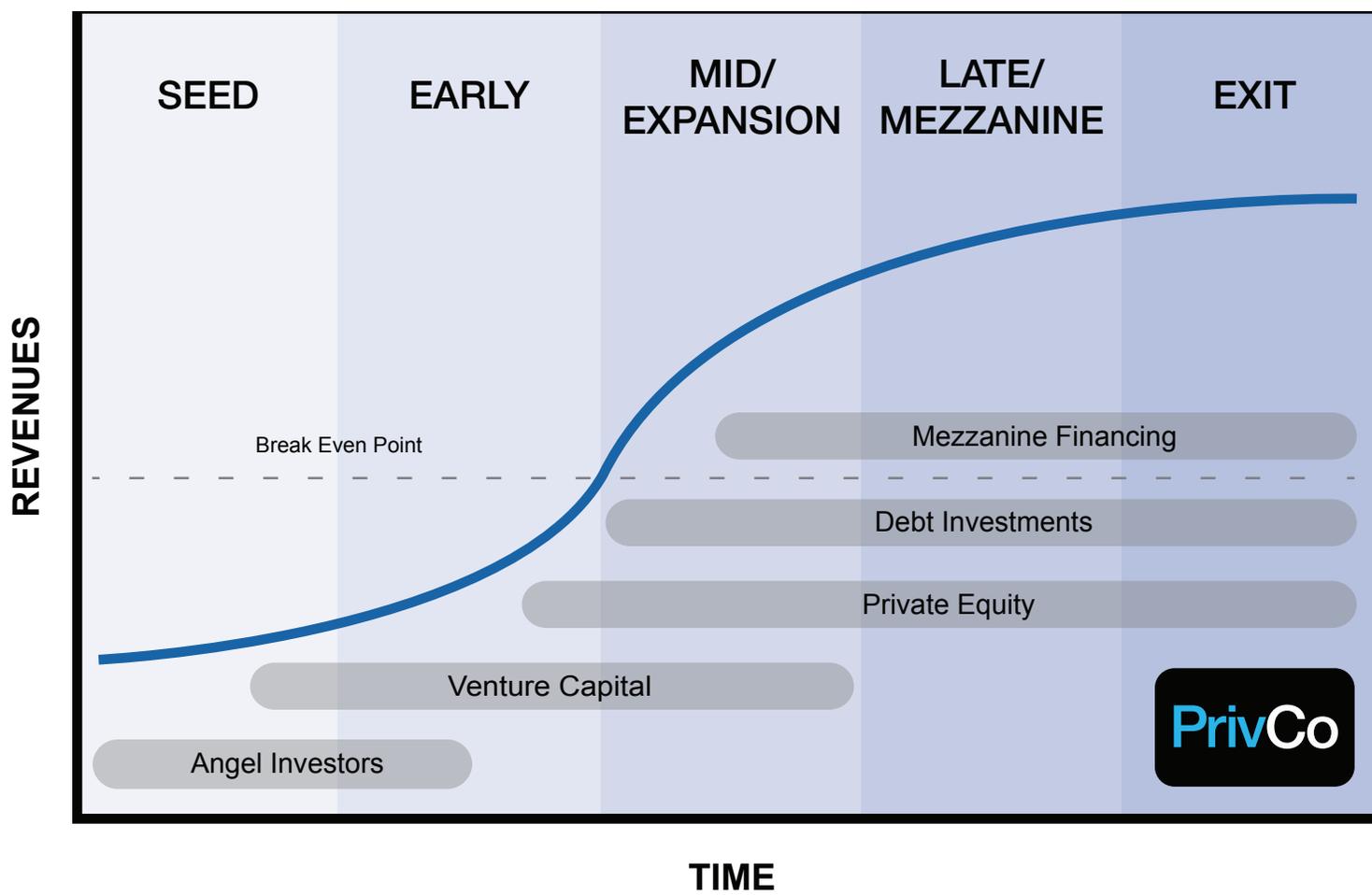
Change of control of the private company may also take place without an M&A transaction due to the death of the private company's Founder and passage of the company to the next generation. (Note that PrivCo has a "Generational Change" tag on a private company when this occurs to allow our users to search by this tag in order to target M&A opportunities or investment opportunities.)

Private Equity & Venture Capital

Overview

Private equity represents a class of investors, their funds, and their subsequent investments, which are made in private companies or in public companies with the goal of taking them private. Private equity investments are primarily made by private equity firms, venture capital firms, or angel investors, each with its own set of goals, preferences, and investment strategies, yet each providing working capital to the target firm to nurture expansion, new product development, or restructuring of the firm's operations, management, or ownership. Aside from the outline of the private company life cycle below, this chapter will focus primarily on private equity firms, which represent the majority of the money in the private equity industry and characteristically invest in the buy-outs of mature companies and venture capital firms, which typically make high risk equity investments in seed, early, and growth stage private companies.

The Private Company Life Cycle



PRIVATE COMPANY LIFE CYCLE STAGES

Seed	Seed capital is private financing provided primarily by friends and family, angel investors, or very early stage venture capital firms. Seed money is often used to fund initial operations, building a product prototype, and product testing. A private company receiving seed capital is pre-revenue and may be in stealth mode, meaning that its operations and products are hidden from the public until ready for market testing and beta launch.
Early Stage	Early stage financing is primarily provided by angel investors or venture capital firms and is used to fund the company's transition to commercializing its product and supporting the firm as it sells to its first customers—this may entail manufacturing and marketing the private company's product.
Mid Stage/Expansion	Expansion capital is exactly what it sounds like: funds used to help support the private company's growth. This may mean helping the company acquire more servers to support traffic to its website, increasing the private company's marketing budget, acquiring or building more factories, launching new products, etc. Expansion capital can come from VC and PE firms but since the private company has profits at this stage, it may not want to give up the equity necessary for taking VC money and will instead turn to other financing methods like debt or mezzanine financing.
Late Stage/Mezzanine	Also known as bridge financing, late stage capital is an investment that often will lead to an exit. Private companies in this stage are profitable, expanding, and may be closing in on an IPO or acquisition by a key player in its industry.
Exit	An exit is a liquidity event such as an initial public offering, direct sale, or buyout that leads to a repayment of all shareholders.

The History of Private Equity and Venture Capital

The Father of Venture Capitalism

Although variations of private equity investment have existed for centuries, the first professional private equity investments date back to the American Research and Development Corporation. In 1946, the American Research and Development Corporation, led by Georges Doriot, Karl Compton, and Ralph Flanders, launched a \$4 million fund. The fund was the first of its kind as it pooled money from both institutions and high net-worth individuals for investments in private companies. By the time that Doriot had retired in 1971, ADRC had made over 150 private company investments, including the first major institutional venture capital success when its portfolio company, Digital Equipment Corporation, provided a significant return upon exit in a 1966 initial public offering. Georges Doriot is now known as the “father of venture capitalism”.

Small Business Investment Act of 1958 & The First Venture-Backed Startup

A significant step towards fostering the private equity industry in the United States was the passage of The Small Business Investment Act of 1958, which provided access to federal capital to investment firms licensed as Small Business Investment Companies (SBICs) that could then be leveraged against private equity funds. As a result, private company investment practices and would-be venture capitalists began to develop. The first venture-backed startup, Fairchild Semiconductor, was funded in 1959.

The First Leveraged Buyout

The 1960s and 1970s witnessed the birth of a series of private equity and venture capital firms that would lay the foundations for the private equity industry that we have today. At the time, private equity deals primarily consisted of venture capital investments in early and mid-stage private companies but the first leveraged buyout transactions began with Lewis Cullman and Herb Weiner in what they called “bootstrap” operations.

Orkin Exterminating had recently undergone a generational change as founder Otto Orkin ceded the company to his children in 1960, which they then took public in 1961, selling roughly 15% of the company in the public market at \$24 per share (PrivCo incorporates both generational and leadership change tags on its private company profiles, allowing subscribers to search for companies that have recently undergone a relevant change). By late 1961, the market had peaked and Orkin was trading at \$30 per share, only to drop to \$18 per share by mid 1962. Despite the fact that Orkin had annual revenues of \$37 million, \$6.7 million in EBIT, and \$10 million in cash, the market had then valued the company at \$43.2 million, down from the \$72 million it had been less than a year prior. By modern day standards, Orkin Exterminating Company was an ideal buyout candidate.

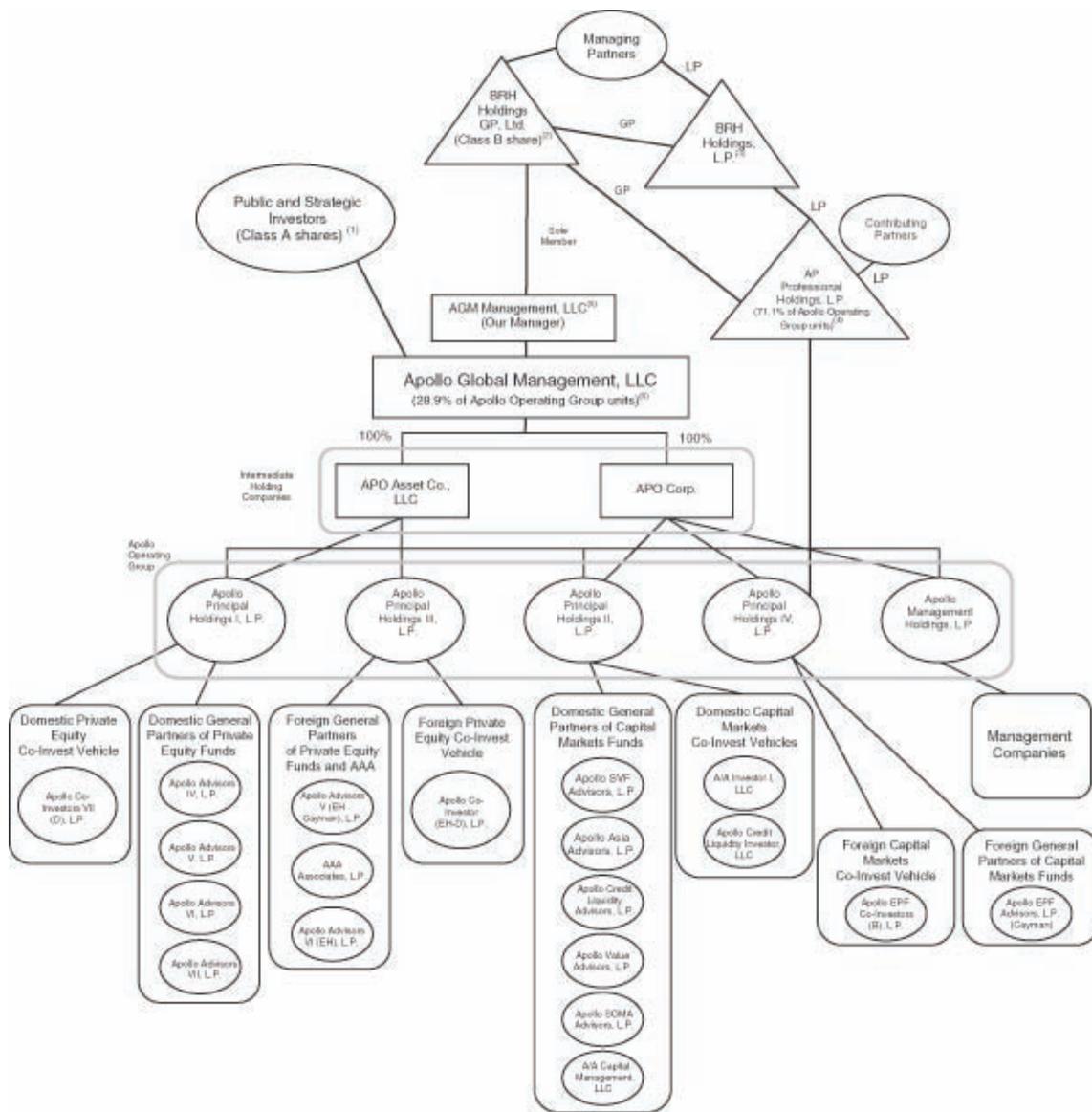
As per Orkin’s report of earnings at \$1.25 per share in October 1963, Cullman’s offering of \$26 per share represented a P/E multiple of 20.8x. In June 1964, Lewis Cullman and Herb Weiner had brokered Rollins Broadcasting’s \$62.4 million buyout of Orkin Exterminating Company, Inc. with a \$40 million loan from the Prudential Insurance Company, \$10 million equity from Rollins Broadcasting (via loan from Chase Bank), \$10 million in sellers notes, \$2.4 million cash on hand, and only \$1,000 personal cash investment.

In July 1964, BusinessWeek called the Orkin Exterminating Company deal one that “truly captures the imagination”. Shortly thereafter, three Bear, Stearns, & Co. bankers would begin to replicate and, through trials and tribulations, began to perfect the leveraged buyout. Jerome Kohlberg, Jr., then head of corporate finance at Bear Stearns, and his protégés Henry Kravis and George Roberts, would leave Bear Stearns in 1976 to found private equity firm Kohlberg, Kravis & Roberts (KKR).

Meanwhile, venture capital firms began to grow in number. In 1973, the National Venture Capital Association (NVCA) was formed and after the economy recovered from a market downturn in 1974, venture capital witnessed its first significant fundraising year as VC firms collectively raised approximately \$750 million in 1978. This crop of early venture capital firms would fund game-changing technology companies like Apple, Compaq, and Electronic Arts.

A small handful of true private equity firms like Warburg Pincus (1966) and Clayton, Dublier & Rice (1978) also emerged in the 1960s and 1970s, later to become buyout powerhouses in the 1980s. These first private equity firms began taking on the same limited partnership organizational structure we see today. In a limited partnership, the private equity firm acts as a general partner, managing investments from a fund composed of money that is contributed by limited partners, which may include pension funds, endowment funds, and high net-worth individuals. In what became known as “2 and 20”, limited partners are expected to pay an annual management fee to the general partner, usually around 2%, in addition to a performance fee, which is usually around 20% of the fund’s profits.

Below is an organizational chart of private equity firm Apollo Global Management, LLC (circa 2007).



Flow of Funds in an LBO

Private Equity Fundraising

Limited Partners

Private Equity Fund
(managed by General Partner)

LBO Investment

Bank Debt / Senior
Credit Facility

Private Equity
Cash Investment

High Yield /
Mezzanine Debt

Target Company

LBO Purchase
Price Proceeds

Selling
Shareholders

Existing Lenders
& Bondholders

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The First Boom and Busts Cycle (1982-1992)

Corporate takeovers grew to become an important facet of American business in the 1970s and 1980s as hostile takeovers and LBOs made the transition from small target firms to large and well-known public companies with the use of significant debt portions.

In 1982, former Secretary of Treasury William Simon's Wesray Corporation bought Gibson Greetings, which was then a subsidiary of RCA, via leveraged buyout. The \$80.6 million deal (\$58 million in equity and \$22.6 million in assumed liabilities) was funded with approximately \$1 million in cash leveraged by a whopping \$79 million in debt. Within 18 months, Wesray Corporation exited on its investment with Gibson Greetings' \$330 million public offering in which Simon saw a personal return on investment of nearly \$66 million. A take private LBO transaction where the target firm is later taken public again is known as a reverse leveraged buyout (reverse LBO).

The rise in LBO activity over the First Boom and Bust Cycle could be attributed to both regulatory and economic factors, including Delaware's Antitakeover Statute of 1982, the overall de-regulation of many industries, the laissez-faire antitrust policies of the Reagan administration, and the introduction of high-yield debt instruments known as junk bonds which provided private equity firms with a significant amount of financing capital. In response to the new trend, corporate managers lobbied for legal restrictions to help insure their ownership and control while increasing debt levels to restructure their companies and payout dividends shareholders.

While Wesray Corporation's fairytale return on Gibson Greeting Cards in the early 1980s characterized the onset of a period of mega buyouts, the most notable buyout of the First Boom and Bust Cycle is by far private equity firm Kohlberg Kravis & Roberts' leveraged buyout of RJR Nabisco in April 1989. Including the assumption of debt, the RJR Nabisco deal was valued at \$31.1 billion, making it the largest leveraged buyout in history.

The RJR Nabisco deal originally began as a management buyout led by the company's Chief Executive Officer, F. Ross Johnson and backed by Shearson Lehman Hutton and its parent company, American Express, at a proposed \$17 billion, nearly half of the final deal value. At the time the MBO was announced in October 1988, RJR Nabisco was trading around \$55 per share, making the \$17 billion price tag or \$75 per share, a significant increase and inadvertently advertising the potential for sky-high advisory fees to all of Wall Street.

The six-week bidding war that took place thereafter, which involved many of Wall Street's big players and is recounted in Bryan Burrough and John Helyar's book, *Barbarians at the Gate: The Fall of RJR Nabisco*, ended with KKR paying a supremely debt-laden \$109 per share. RJR Nabisco, then loaded up with over \$20 billion in debt, would require a \$6.9 billion refinancing plan to stay afloat in 1991. In fact, many of the buyouts throughout the 1980s resulted in a bankrupt target company as a result of the sizeable debts they were left with and thus the term "corporate raiders" became associated with private equity buyout shops.

Michael Milken, then head of investment bank Drexel Burnham Lambert's high-yield bond division, is popularly cited for the development of the high-yield market which substantially led to the incredible fundraising capabilities in the 1970s and 1980s and, subsequently, the increased number of leveraged buyouts. In March 1989, Milken was indicted on 98 counts of racketeering and fraud by a federal grand jury and in April 1990 pleaded guilty to six counts of securities and tax violations. Michael Milken's total fines of \$1.1 billion and 10 year jail sentence (he ended up serving 22 months) aided in the collapse of the junk bond market and thus, the leveraged buyout boom. Drexel Burnham Lambert would file for Chapter 11 bankruptcy protection in 1990.

The Second Boom and Busts Cycle (1992-2002)

After achieving such a negative, greed-ridden connotation in the 1980s, the private equity buyout industry returned in the 1990s, after a short dormancy, with less use of leverage and a stronger focus on the target firm's long-term development. Despite its relative lack of growth when compared to the buyouts market in the 1980s, venture capital had begun to take center stage by the mid-1990s. The turning point for VC was largely due to the mass appeal of the information age, the low interest rates of the late 1990s, and the overtly successful IPOs of many high-tech companies that are now household names like Google (www.google.com), Yahoo! (www.yahoo.com), E-bay (www.ebay.com), and Amazon (www.amazon.com).

Interest rates in the United States are targeted by the Federal Funds Rate, which is governed by the Federal Open Market Committee (FOMC). The Federal Funds Rate is the interest rate that depository institutions charge to lend balances at the Federal Reserve Bank to other depository institutions. When the Open Market Committee wishes to increase interest rates, government securities are purchased and the economy's money supply goes down. Since deposit institutions are required by the Federal Reserve to maintain above a minimum reserve requirement, typically 10% of demand accounts (the total funds that the deposit institution holds in the form of checking accounts), deposit institutions often borrow money from other deposit institutions to cover increases in outgoing loans. The economics of supply and demand suggest that a decreased supply leads to an increase in price, which, in this case, is an increase in the interest rate that banks charge each other when the supply of money decreases and thus the interest rates they must charge to make loans to other institutions and individuals.

In the early 1990s, interest rates were incredibly low, in part to help stimulate spending and pull the United States out of a recession (the 22.6 percent collapse of the Dow Jones Industrial Average in October 1987, which was larger than the crash in 1929 that led to the Great Depression, is referred to as "Black Monday"). When the economy began to grow rapidly with the dot-com bubble of the late 1990s, the Federal Open Market Committee responded to curb growth by increasing the Federal Funds Rate—a total of six times 1999 and 2000.

In the end, the surge of interest in the Internet led to a large number of irresponsible business strategies and irresponsible investments, almost as if anyone with a reasonably interesting idea and a dot-com address could receive VC money. Internet companies with little to no profits were going public and enjoying significant stock price increases often based solely on industry speculation. On March 10, 2000, the NASDAQ stock market dropped 83.9 points and the dot-com bubble began to burst. By April 4, 2000, the NASDAQ fell to 4369. In the two years that followed, venture capitalists unloaded many of their investments at a loss.

The Third Boom and Busts Cycle (2003-2007)

With the passage of the Sarbanes-Oxley Act of 2002 (SOX), in part to prevent financially unhealthy and cash poor companies from reaching an IPO as they had in the 1990s, the costs of reporting and governance that are associated with being a public firm grew significantly, helping make a go private transaction appealing to many public companies. Since privately held firms are not heavily regulated by governmental agencies like the Securities and Exchanges Commission or regulations such as SOX (also known as the, "Public company Accounting Reform and Investor Protection Act" and the "Corporate and Auditing Accountability and Responsibility Act"), this freedom can have major advantages. Without these strict regulations, private companies have greater operational flexibility and can focus more on long-term goals rather than quarterly earnings.

By the time that the economy had recovered from the burst of the dot-com bubble, interest rates dropped to historically low numbers. Private equity firms were raising funds that were larger than ever before. For the larger private equity

buyout shops, what was once a \$5 billion fund became a \$15-20 billion fund, allowing them to complete leveraged buyouts with deal sizes that rivaled and surpassed KKR's \$31 billion buyout of RJR Nabisco, which was previously the largest buyout on record.

The historically low interest rates of the early 2000s were soon combated by monetary policy tactics of the Open Market Committee, which would raise the Federal Funds Rate 17 times between 2004 and 2007. In order to remain competitive in lending to massive buyout firms, banks began to offer less restrictive terms on the debt-servicing capabilities of the PE firms and their targets due to their significant bargaining power. These covenant-lite loans provided increased loan repayment flexibility for the borrower yet increased risk for the lender as typical covenants that signaled a company was in trouble such as a requirement to report EBITA or loan to value ratios were not included in the loan agreement. Commonly, banks would hedge their increased risk in credit derivatives. In September 2007, Kohlberg, Kravis & Roberts closed a \$26.4 billion LBO of First Data Corp.—a deal which included a record \$14 billion in covenant-lite loans. In hindsight, covenant-lite loans have not seemed to perform worse than loans with covenants.

In October 2007, a consortium of investors led by Kohlberg, Kravis & Roberts, the Texas Pacific Group, and Goldman Sachs Private Equity took TXU (since renamed as Energy Future Holdings) private via leveraged buyout for \$48 billion—making it the largest private equity buyout in history. Just three years prior, in 2004, KKR and TPG had participated in a \$3.6 billion buyout of Texas Genco, which they had sweetly returned a \$4.9 billion profit on in 2005. In the Energy Future Holdings deal, which had required considerable lobbying efforts as nearly one-fifth of the United States' energy production was at stake, the debt holders and private equity firms have since taken a loss and, although Energy Future Holdings generates a significant amount of cash, the company has considerable interest payments and a tower of debt due in 2014.

A lot had changed in the private equity scene within those three years, most notably that the economy had been weakened by the onset of the global credit crisis in the summer of 2007, making what was once cheap and plentiful debt harder to come by. Although partly due to the credit crisis, many of the large pre-credit peak buyouts left the target companies unable to support their debt and either defaulting or falling into financial distress.

Over the following few years, there was a large drop in the number of leveraged buyouts that were completed as well as some notable changes that were made in deal term practices which were aimed to increase the accountability of the buyout firms, including the weighted importance of reverse termination fees, exclusive remedy provisions and specific performance provisions, financing outs, and sponsor guarantees. Capital infusions, or cash injections from the buyout firms into the target company, grew rare and when used were done mostly to avoid covenant violations rather than reducing the debts that targets were buckling under.

Types of Private Equity-Related Transactions

Due to the high costs associated with being a public firm, take private transactions have become a modern day phenomenon. By taking a company private, a firm is able to reduce or eliminate the burdens of the Sarbanes-Oxley Act, increase corporate control and strategy mobility, and focus on long-term strategy without worrying about shareholders, filings, and quarterly results—not to mention that the process can be incredibly lucrative for the private equity firm that initiates the take private transaction and takes advantage of the large value gap. A value gap represents the difference between a company's value under its current management policies and an expected higher company value given policy changes, restructuring, and a redeployment of assets that may not directly align with the company's core operations. The value gap itself is arguably affected by the debt-intensive means of taking the company private which forces the company into a period of financial distress after the transaction, thus forcing its management to restructure the firm, making strategic decisions that enhance the company's value, and trim out unprofitable or low payoff business components.

PRIVATE EQUITY-RELATED TRANSACTIONS	
Leveraged Buyout	A Leveraged Buyout is a situation in which an investor acquires a controlling interest in a given private company's equity by borrowing a large portion of the capital to finance the transaction. The acquired private company's assets are often used as collateral against the borrowed capital. In a leveraged buyout situation, a combination of debt instruments from bank and capital markets are deployed.
Management Buyout	In a Management Buyout (MBO), the private company's existing managers acquire a huge chunk of the private company. The managers attempt a buyout for multiple reasons including, to save their jobs, when the business is at risk for bankruptcy or if a third party external purchaser would bring about new, undesired, management changes. Management Buyouts would also be used to ward off hostile buyers.
Management Buy-In	In a Management Buy-in (MBI), an external entity accumulates the required capital to become the new management of the private company. The difference between a management buyout and management buy-in is that in a MBO, the purchaser is already a part of the private company and in the case of a MBI, the purchaser is an external party.
Buy-In MBO (BIMBO)	A Buy-in Management Buyout (BIMBO), the situation is a mix of both MBO and MBI. The outside parties and the existing managers or individuals form the new management team of the private company.
Institutional Buyout	Institutional investor, like a private equity firm, acquires a major controlling stake in a private company. Unlike a MBO, where the management has a majority stake, in an Institutional Buyout, the private equity firm becomes the controlling shareholder. In some cases, the private equity firm which acquires the private company may sometimes retain the current management or hire new/additional management by offering stakes in the private company.

PRIVATE EQUITY-RELATED TRANSACTIONS *(continued)*

Secondary Buyout	A Secondary Buyout is a leveraged buyout in which the private equity firm, which owns a major stake in the private company, may offer to sell its investment in a given private company to another external party, such as another private equity firm. Akin to passing of a baton to a new owner, Secondary Buyouts are popular due to the liquidity they offer.
Add-On	In a typical Add-On transaction, private companies are acquired as part of a consolidation investment strategy. A consortium of private equity firms acquires private companies that are active in the same or a related industry with the intention to merge or combine them together via an Add-On transaction, thus often increasing value, fostering revenue growth, and gaining a larger market share.
Dividend Recap	In a Dividend Recapitalization, a private company (most often post-buyout) takes on additional debt to issue a special dividend to private investors or shareholders. A private equity firms' portfolio private company can authorize a dividend recapitalization as a substitute for selling equity stake in the private company. It serves as an opportunity for private equity firms to recoup a portion or the complete amount of their investment used to purchase their initial stake. However, since a Dividend Recapitalization reduces the credit quality of the private company, common shareholders and creditors often do not consider it a favorable option.

Private Investment Securities Filing Requirements

Even to raise the most basic Angel Investor funding, it's very important that private companies follow securities laws, make full written disclosure to investors of the terms of the offerings and how risky the investment is (all the things that could go wrong and why the investor may lose their entire investment), and to raise money primarily or solely from sophisticated investors (known as "accredited investors").

Full Disclosure: Private Placement Memorandums (PPM)

The purpose of the Private Placement Memorandum (PPM) is to make full and thorough disclosure to the prospective investors so that the private company is protected from later investor "sour grapes" if the private company goes under and the investor loses his or her investment. The PPM contains detailed information about the private company's products and services, its financials (including the private company's income statement, balance sheet, and statement of cash flows – see PrivCo Private Company Knowledge Bank "Terms and Definitions"), and especially what are known as Risk Factors. The section on Risk Factors details everything that could possibly go wrong – from key employees quitting to competition to even acts of war and terrorism disrupting the business. In a nutshell, it can sometimes read like a parade of horrors.

The Private Placement Memorandum also must discuss the private company's competition (PrivCo.com can of course be helpful in preparing this section of the PPM by allowing you to quickly compile real and potential competitors using our proprietary PrivCo Industry Classification System (PICS) codes. A full and honest discussion of the private company's strengths and weaknesses versus its actual and potential competition is recommended, as is listing many of these competitors by name. This can be done under Risk Factors: Competitors, or as a separate section on Competition.

State and Federal Securities Filing (including "Blue Sky Laws")

In the United States, state and federal securities laws require filing a legal document on the offering when stock in a private company is sold or transferred. Federal law applies in every case no matter where the private company is headquartered in or where the investor is based. In addition to that, there are state securities laws that vary by state (these are known as Blue Sky Laws – see PrivCo Private Company Knowledge Bank Terms and Definitions). With the Blue Sky Laws, each state has its own unique securities registration requirements which include registration by exemption, coordination, and private offerings. Under Blue Sky Laws, each state may also have different limitations on the number of private investors from that state who invest in the private company.

What Happens If A Private Company Doesn't Register: Federal and state registration (and providing the written Private Placement Memorandum containing full disclosure) is critical for a private company raising funding, even small amounts from Angel Investors. Failing to register can:

- Increase the private company's retroactive securities filing fees, in some cases doubling them.
- Require the private company to return investment capital to its investors, even if already spent.
- Under Blue Sky Laws, depending on the state, result in a ban on the private company from raising future investment capital in that particular state.

Angel Investors: Raising Private Investment Capital Mainly or Only from Sophisticated Investors

As discussed in the section of the PrivCo Private Company Knowledge Bank on the various types of private market investors, the private company's most likely avenue for raising private investment capital is often from Angel Investors. This is especially in the earlier stages of a private company (the start-up company phase). Because of securities laws, private companies are strongly advised to raise money mainly or only from Accredited Investors. As defined by Rule 501 of Regulation D of the Securities Act of 1933, these private investors need to meet one of the following requirements:

1. Be a bank, insurance company, registered investment company, business development company, or small business investment company;
2. Be an employee benefit plan, if the plan has total assets in excess of \$5 million;
3. Be a charitable organization, corporation, or partnership with assets exceeding \$5 million;
4. Be a director, executive officer, or general partner of the company selling the securities (basically, one of the private company's Founders or senior executives);
5. Be an individual who has a net worth (by himself or with the person's spouse), of more than \$1 million at the time of the private investment (excluding the value of their primary residence);
6. Be an individual with income of more than \$200,000 a year in each of the two most recent years, (or have joint income with a spouse of more than \$300,000 in each of the two most recent years), AND expect to have similar income in the current year of the investment; or have a trust with assets of more than \$5 million (not formed for the sole purpose of making the private investment);
8. Be a business or other entity in which all of the equity owners are accredited investors.

Securities laws strictly limit the number of non-sophisticated investors participating in the investment round (depending on the size of the investment). Raising money from non-Accredited Investors can result in exposure of the private company to lawsuits from them demanding the return of their investment, especially if things go wrong. So doing so is like giving these investors a free option: in a nutshell, heads they win, tails they break even by simply demanding their money back. So it's most advisable for a private company to only raise angel or other private investment capital from Accredited Investors.

Venture Capital Investments

Venture capital is a subset of private equity. Therefore all venture capital is private equity, but not all private equity is venture capital. Venture Capital is the early stage form of private equity where investors focus on investing in startup (highly risky) ventures. Private equity refers to the holding of stock in unlisted private companies – private companies that are not quoted on a stock exchange. The funds raised through private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a private company's balance sheet.

Venture Capitalists invest in high-risk, high-return investments, with an investment horizon of six or seven years. The venture capitalist's final goal is to either take the private company public (Initial Public Offering) or Trade sale. Venture capital manages risk typically with staged investments in which the private company has to meet certain milestones before qualifying for additional rounds of financing.

Raising Venture Capital - Advantages

1. Venture capital provides long term equity financing which while creating a solid capital base for future business expansion. It also brings in a host of value added services.
2. Venture capitalists provide private companies with ongoing strategic, operational and financial advice.
3. Having venture capitalists as investors provides lot of confidence to the stakeholders and customers.
4. Investments from venture capitalists also ensure proper corporate governance from the initial stage.
5. The venture capitalist offer strong business expertise in their area of business which ultimately helps the business to perform well against the market competition.
6. The venture capitalist comes with network of contacts that can add value to the private company, such as in recruiting key personnel, providing readymade international markets, introductions to strategic partners, and if needed co-investments from other venture capital firms when additional rounds of financing are required.
7. The venture capitalist can also provide additional rounds of funding should it be required to finance growth.
8. Venture capitalists are experienced in the process of preparing a private company for an initial public offering.

Raising Venture Capital - Disadvantages

1. Investee private companies are required to give up controlling stake in the private company.
2. Venture capitalists tend to influence the strategic direction of the private company.
3. Venture capitalists are generally interested in taking control of the private company if the management is unable to drive the business.

VENTURE CAPITALIST INVESTMENT EVALUATION CRITERIA

Business Concept Fit	Whether the business proposal fits with the venture capital firm's defined investment objectives, the business/technology space, stage of growth and synergy with portfolio private companies.
Management	Venture Capital will consider investing in a business with a strong management team that shows organization, strong business concepts and having the ability to recruit a competent talent along the way.
Market	Venture capital firms invest in private companies with a focus on filling a real need within a very large and growing marketplace.
Barriers to Entry	Necessary to maintain a competitive advantage. Typically, such barriers to entry include things like proprietary intellectual property, a unique understanding and experience within a market niche, or strong industry partnerships.
Profitability	Businesses with a reasonable and verifiable path to profitability are favored.
Exit Strategy	An exit strategy that provides liquidity within an acceptable time frame is critical to achieving a VC's investment objective.

Venture Capital Term Sheets

A Term Sheet is a document that outlines key financial data and other terms of a proposed investment by a venture capital firm into a private company. Investors use a Term Sheet to arrive at a preliminary and conditional agreement. Those key terms will be used to form the basis for drafting the investment documents. With the exception of certain clauses (commonly those dealing with confidentiality, exclusivity, costs and break-up fees) provisions of a Term Sheet are not intended to be legally binding. The Term Sheet is negotiable before it is transferred to the final legal document. A Term Sheet will usually contain certain conditions which need to be met before the investment is completed – these are known as conditions precedent.

The Subscription Agreement contains details of the investment round, including the number and class of shares subscribed for, payment terms, representation of shareholders and warranties about the condition of the private company and its key assets. These representations and warranties will usually be qualified by a disclosure letter and supporting documents that specifically point out any issues that the founders believe the investors should know prior to the completion of the investment.

The Shareholders' Agreement will usually contain investor protection clauses; including consent rights, rights to board representation and non-compete restrictions. The Constitution will include the rights attached to the various share classes, the procedures for issuance, transfer rights of shareholders and board meeting procedures. Once agreed upon by all parties, lawyers use the Term Sheet as a basis for drafting the investment documents. The more detailed the Term Sheet, the fewer the commercial issues that will need to be agreed upon during the drafting process. Once the provisions of the Term Sheet have been negotiated and agreed upon, a Subscription and Shareholder's Agreement is drafted that outlines the provisions in a legally-binding document.

Bankruptcy & Restructuring

Overview

Bankruptcy in the U.S is permitted by the United States Constitution, which authorizes Congress to enact uniform laws on the subject of bankruptcies throughout the United States. Bankruptcies are initiated with a petition filed by the debtor or on behalf of creditors (involuntary bankruptcy) in an attempt to recoup a portion of the debt or force a restructuring. Although some law relevant to bankruptcies can be found in other parts of the United States code, the Bankruptcy Reform Act of 1978 is the most recent addition to the United States Code. Codified under Title 11 of the U.S Code, the Bankruptcy Reform Act of 1978 is commonly referred to as “Bankruptcy Code”.

Chapters of Bankruptcy

Depending on the circumstances, private companies under the Bankruptcy code may file a petition for relief under different chapters of the code. Title 11 is comprised of nine chapters, of which six chapters are designated for filing petition. The remaining three chapters provide rules to govern those petitions.

Bankruptcy filing specifications differ widely among various countries, leading to higher and lower filing rates, depending on how easily a private company or a person can complete the process.

Chapter 7: Liquidation

Chapter 7 is one of the two primary options available to private companies in distress. Chapter 7 is also referred to as Liquidation. A Chapter 7 proceeding is one in which a business or firm is terminated or stops operating. The business assets are sold and proceeds of the sale are distributed to creditors.

As does a public company, a private company qualifies for filing a Chapter 7 bankruptcy. The portion of the debt that cannot be repaid through liquidation is absolved. Private companies generally try to avoid Chapter 7 bankruptcy, because it terminates all business operations with no opportunity to reinstate at a later date. Income generated after the bankruptcy filing is considered in the proceedings.

Example: Secured creditors take less risk because the credit that they extend is usually backed by collateral, such as revenue or other assets of the private company. After all debts with secured creditors have been settled, the subordinated levels of debt, such as unsecured creditors, can claim repayment. After all the private company’s debt is settled, equity investors are able to stake a claim on assets.

Chapter 11: Reorganization

Chapter 11 is a complex form of bankruptcy and is generally filed by private and other corporations who aim to restructure their capital allocation to operate more efficiently and effectively, primarily by eliminating debts and contracts (such as office leases or union contracts) that they can no longer afford. Chapter 11 involves the reorganization of a debtor private company’s business affairs, assets and liabilities. The bankruptcy gives the debtor a fresh start, subject to the debtor’s

fulfillment of its obligations under its plan of reorganization (like public companies, a private company must file a Plan of Reorganization for the Bankruptcy Court's approval demonstrating it will be viable after exiting bankruptcy.) Chapter 11 bankruptcy can also be used to liquidate some of the assets of a private company and pay the creditors from the proceeds of the sale (these are referred to as "Section 363 sales transactions; PrivCo tags M&A transactions resulting from a bankruptcy order as a Section 363 sale).

The Bankruptcy Code 11 is available to a company (corporations, partnerships or sole proprietorships) that is plagued by severe financial difficulty. Permission for filing Chapter 11 bankruptcy is given, if debt repayments can be abated or postponed. The private company is protected by an automatic stay that is initiated upon approved filing of the petition. As a result, creditors cannot take any action against the debtor. The stay eases the financial burden of the debtor, during which negotiations can also take place to try to resolve the difficulties in the debtor's financial situation.

After filing for bankruptcy, the debtor is relieved of payments for 120 days, during which, the debtor must formulate and file a plan of reorganization with the court of bankruptcy. If the debtor fails to submit a plan during the 120 day period, or if creditors fail to adhere to the debtor's plan during the first 180 days, creditors are allowed to submit a plan of reorganization. Sometimes compromises must be made on behalf of the debtor and associated creditors when the bankruptcy court is faced with conflicting plans of reorganization. Often creditors of the companies such as banks and lenders take some or all of the stock of the private company upon exit from Chapter 11 and essentially become the new owners of the company. In some cases the private company and its creditors agree in advance on what the outcome will be and will file what is referred to informally as a "prepackaged bankruptcy", which also will tend to be completed much faster than an ordinary bankruptcy since the private company and its creditors agree in advance and don't need to "duke it out" in court over what a fair outcome will be.

Example: Private company Merisant Worldwide, Inc. and its affiliates filed for protection under Chapter 11 bankruptcy in the U.S Bankruptcy Court for the District of Delaware. This move was intended to restructure the private company's balance sheet and improve its long-term growth and financial well-being. The private company's operations in the US and worldwide proceeded without interruption after the bankruptcy filing. Merisant felt that restructuring its balance sheet was the ideal way to increase the success of its products in the market.

Private Company Restructuring

Corporate restructurings can also take place without the involvement of a bankruptcy court, saving the significant legal costs to both the private company and to the creditors of a formal court process.

Corporate restructurings all aim to create shareholder value. A restructuring is an adjustment of ownership, operations, assets, or capital structure of a private company in order to improve operating performance, optimize capital structure and enhance public perception. Before known as a simple balance sheet reconfiguration, restructurings now include a variety of financial transactions from mergers, asset sales and special dividends to share repurchases. Restructurings have been used to lever and delever the balance sheet, concentrate equity ownership, or realize value of a subsidiary.

Over the past 20 years, corporate restructurings have been on the rise as institutional investors become more active and vocal. Institutional investors have begun to make demands of management and the board of directors. In some cases, institutional investors wage proxy battles in order to enhance shareholder value.

Given the prevailing market conditions over the past three decades, hostile take over activity such as leveraged buyouts and hostile acquisitions have been on the rise. Nevertheless the value of acquired private companies is not always reflected in the stock price of the acquirer. Therefore, private companies have been focusing on improving core businesses, divesting poor performing assets and highlighting strong performers.

Creating Value in Restructuring

Corporate restructuring comes in many flavors, including financial and transactional methods. Corporate restructuring can include a reconfiguration of the balance sheet via issuing a special dividend, share repurchases, or recapitalizations. Financial restructurings are designed to make the capital structure more efficient or can be used to defend against a takeover effort. Transactional restructurings include a reconfiguration of assets or operations. Such methods are typically divestitures, spin-offs, split-offs, and equity carve-outs. Other less common transactions are tacking stock, leveraged buyouts, leveraged ESOPs, or complete liquidations.

CREATING VALUE IN RESTRUCTURING

Internal Restructuring	A private company evaluates its internal process, capital structure, and strategic priorities. The private company then refocuses its attention and resources on areas that will maximize operating performance. This can include reallocating capital to grow key assets or entering new markets.
Special Dividend	A Special Dividend is a capital distribution to shareholders. Even if private companies do or do not pay regular dividends, a special dividend can be issued to reconfigure the private company's balance sheet or alter the private company's leverage ratio. This can be done from existing cash deposits or from newly issued liabilities.
Recapitalization	Recapitalization requires that the private company take on additional debt or reduce their equity by repurchasing shares. Recapitalizations are usually done to alter the ownership of the private company. The main goal of initiating a recapitalization is to keep the private company's capital structure more stable and in some cases boost the stock prices of private companies. Recapitalizations are done by cash-rich public companies that are threatened by a takeover.
Leveraged ESOP	Although uncommon, Leveraged Employee Stock Ownership Plans are typically used to concentrate the ownership of a private company in the employees' hands. This is another method to defend against a possible takeover. An ESOP is an employee stock ownership plan where employees own a piece of equity in the private company. Leveraged ESOPs are initiated by borrowing capital to capture a majority of the equity at one time. This equity can then be vested over a period of time to the employees. Leveraged ESOPs drastically alter both the capital structure of a private company, by increasing the liabilities, and the ownership concentration from the original owners/management to the employees.
Sale	In this case, Sale represents a direct divestiture of a division or subsidiary of a larger private company through a private sale of its assets or its equity. This sale represents a taxable transaction. Proceeds of the sale can be used to pay down debt, reinvest in core growth, or can be paid out as a special dividend to shareholders.
Split-Off	A Split-Off is the separation of a subsidiary from the parent by splitting the shareholders of the parent private company's stock from the shareholders of the subsidiary's stock. Most split-offs are tax-free transactions and used to downsize a private company or defend against a hostile takeover.

CREATING VALUE IN RESTRUCTURING

Spin-Off

In a Spin-Off transaction, the private parent company separates the shares of a subsidiary from the original private company shares and distributes those shares, on a pro-rata basis to its shareholders. Shareholders may in turn sell the shares on the open market. In essence, two separate entities are formed in which the stockholders are issued the shares in the legal subsidiary proportional to their original holdings in the parent private company. Both the entities have their own management and run individually after the spin-off. The distribution of the subsidiary's stock to shareholders is in the form of a dividend. This is typically a tax-free transaction for both the shareholders and the parent.

Equity Carve-Out

An Equity Carve-Out is a sale of a portion of equity in a subsidiary to the public via a public offering. The private parent company retains the majority stake in the now public subsidiary, usually greater than 80%. With ownership of over 80%, the private parent company still retains the right to undertake spin-offs and split-offs on a tax free basis.

Tracking Stock

Tracking Stock is a special class of stock with earnings or dividends that are attributed to a specific division or subsidiary of a private company. Tracking stock is a way for a private parent company to separate certain divisions of its private company and allow shareholders to benefit from earnings and capital appreciation without having to give up control of the assets associated with the particular division.

Leveraged Buyout

While characteristically a take-private transaction, leveraged buyouts are acquisitions with a highly leveraged capital structure where the majority of the cash flow from the acquired company, division, or subsidiary is used to service and repay the loan. Leveraged buyouts may be used to enhance shareholder value, counter takeover threats or realize the value of undervalued assets.

Reasons Behind Restructuring

The overarching goal of a restructuring is to increase shareholder value but there are many reasons behind restructuring.

Focusing on Core Business

Groups of shareholders can actively demand management to increase shareholder value by focusing on the private company's core businesses. Pressure from shareholders can cause management to create a restructuring plan that will focus the private company's resources on core businesses.

Eliminating Poor Performers

Poor performance of a subsidiary due to industry conditions, poor management, or ineffective corporate strategy can be detrimental to the financial performance of the parent private company. Therefore, a parent private company commonly divests the poorly performing subsidiary. This may immediately improve the financials of the parent private company by not including the poorly performing financials of the divested subsidiary in the consolidated statements. As a result the parent private company might eliminate capital outflows that were needed to fund the failing business. Additionally, a divestiture of a failing business will provide additional capital the parent private company can use to stimulate growth in its core businesses. Finally a divestiture, if communicated correctly, will boost morale of existing employees and improve the public perception of the parent private company.

Highlighting Undervalued Assets

Large private companies may have smaller subsidiaries that are high growth or strong performing private companies that may not be properly valued since their performance is hidden by the size of the conglomerate. In such a case, the parent private company may want to divest a part or all of the strong performing private company via a sale, spin-off, split-off or equity care-out.

Highlighting the positive attributes of the undervalued business is a benefit to both the shareholders of the parent and the divested private company. Divesting the smaller private company allows it to raise their own capital via debt and equity markets that is separate from that of the parent private company. By using their own cost of capital, the divested private company doesn't need to vie for capital allocation from the parent private company. Additionally, the divested private company can be properly valued by the market based on its respective multiples. Furthermore, the parent private company receives proceeds from the divestiture that it can reinvest or issue to shareholders.

Realizing Value from Stronger Business

Where strong performing businesses are not valued by the market, there is an opportunity for the parent private company to realize the value of this business through a sale or divestiture. Proceeds from this sale can be used to develop other parts of the private company's businesses or pay down debt.

Realigning of Capital Allocation

A private company with multiple business units, funding and capital allocation issues restrains optimal operations of its subsidiaries. There are often internal conflicts as management teams vie for capital from the parent private company. This leads to potentially inefficient allocation of capital where certain businesses will have excess capital while others will be under funded. Inefficient capital allocation restrains the growth of subsidiary private companies. In such a case, separation of the different business lines allows each newly divested private company to raise capital to service their needs.

Avoiding Takeovers

Restructurings have been used to avoid takeovers. Selling or spinning off a key business unit can be an effective deterrent for takeovers since acquirers will have to pay capital gains tax on spin-offs of the target private company that were initially tax-free. Increasing leverage can also help defend against takeovers, but the effect on operating flexibility must also be taken into account.

Lowering Borrowing Costs and Optimizing Capital Structure

Different operating divisions of a larger corporation have different operating risks and capital requirements that may overshadow each other. In such cases the parent private company may find itself over leveraged. One of the main goals of restructuring would be to reorganize the capital structure of the private company to lower borrowing costs.

The capital structure of a private company should always strive to optimize funding costs. The goal is to balance between the high costs of equity and the lower costs of debt and the benefits and detriments of both methods of funding. Funding operations through debt issuances can lead to financial distress as the interest expense to service the loan can consume cash flow. Divesting a business division is a great way for a private company to improve its financial position.

Providing Management Incentives

Management teams of a subsidiary often operate off the incentives based on the performance of the parent private company as a whole. Stock option plans that are given to executive level management teams of subsidiaries that are based off the stock performance of the parent private company are not always appealing if the operating activities of the subsidiary are not properly valued by the market. Separating the subsidiary from the parent creates lucrative incentives for management whose compensation is now directly based on their division's performance.

Pre-IPO Housecleaning Process

Prior to the initial filing of an S-1, firms that intend or explore the option of going public must enter a restructuring process. This pre-IPO restructuring process is known as the "House Cleaning" process and is done to ensure that the firm is SEC and Sarbanes-Oxley compliant in terms of accounting, compensation, contractual agreements, corporate structure, and tax-related considerations.

This process will begin with a combination of marketing/public relations and auditing processes and may prove quite costly, especially in combination with SEC filing fees. The time between the initial S-1 filing and the first day of trading, the firm must report as if it were a publicly traded firm each quarter. For firms that are unable to quickly achieve compliance, this may prove quite costly and often will result in an IPO withdrawal filing.

Methods to Assess Forms of Restructuring

There are two basic forms of restructuring: financial and transactional. A financial restructuring usually takes place when the operating performance of a private company is doing well but the capital structure needs improvement. Transactional restructuring takes place when there is a need to reconfigure both the operating effectiveness and the capital structure of a private company. Many times financial and transactional restructurings can occur simultaneously.

Tax Basis in Different Businesses – Tax basis is one of the most important considerations in a restructuring process. In a situation where the tax basis is high the parent private company may consider a taxable direct sale of the asset where as when the tax basis is low there parent private company may consider a tax-free alternative such as a spin-off or a split-off.

Break-Up Valuation – Before deciding on a type of divestiture, a parent private company should perform a break-up valuation to determine the extent to which a subsidiary is under or over-valued. The break-up valuation will determine which type of divestiture will be most appropriate.

Leverage – If the parent private company is over-leveraged, it may force the parent private company to sell certain assets where as on the other hand if the parent private company is underleveraged it may wish to pay a special dividend to shareholders or take on additional debt.

Operating Performance – The operating performance of the parent private company is the summation of the performance of its individual subsidiaries. The parent private company may wish to divest poorly performing divisions in an effort to optimize operating efficiency or divest strong but undervalued business units to realize their true value.

Private Company Makeup – The corporate culture and overall structure and strategy of a private company may occasionally differ from its subsidiaries. It may be necessary to divest business divisions whose operations or goals conflict with overall strategic direction of the parent.

Threat of Takeover – A parent private company may consider restructuring to defend against a threat of hostile take-over. The type of threat will determine the restructuring options available to the targeted private company. If the acquiring private company plans to use the excess cash of the targeted private company to help finance the acquisition the targeted private company may pay out a special dividend to shareholders thereby reducing the ability of the acquirer to complete the acquisition. On the other hand if a the acquiring private company is targeting specific assets of a private company the targeted private company may choose to divest those assets to realize their value on the open market thereby foiling the efforts of the acquirer.

Methods of Financial Analysis for Restructuring

There are many different types of financial analysis that must be preformed prior to a restructuring transaction. Valuations must be preformed of the targeted and acquiring private company with analysis of divested divisions or business units and their impact on shareholder value.

Break-Up Valuation Analysis

Break-up valuation is the central technique used in all types of transactional restructurings, specifically all transactions that involve any types of divestitures. A typical break-up valuation has four steps.

- First each subsidiary or business division is valued as stand alone entities. Typically valuations use the cost of capital of the parent private company.
- Second, the ranges of values for each business division are summed to create a composite range of values for the firm as a whole.
- Third, a range of values – or deductions – is placed on the corporate overhead.
- Fourth, the parent private company's overhead and net debt is deducted from the total value of the stand alone businesses. The result is the implied equity value of the break-up valuation of the private company.

Capital Structure Analysis

Leverage is an important factor when considering restructurings. Leverage can be increased to defend against take-overs, pay out special dividends, repurchase shares, or optimize capital structures. During a divestiture transaction, leverage of the parent private company and the intended divestiture target needs to be taken into account.

Each industry and sector will have specific leverage ratios that are acceptable for private companies across that industry. When analyzing a restructuring transaction it is important to obtain comparable ratios for private companies within that industry since capital requirements, growth opportunities and cash flow trends change.

With the comparable valuations completed, one now has a framework by which they may determine the impact of the proposed restructuring. In divestitures, the capital structures of the parent and the divested private company must be analyzed. It is important to make sure that the capital structure of the divested business is appropriate for its place in the business cycle.

Accretion/Dilution Analysis

Accretion/dilution analysis is the assessment of the impact of a transaction on the earnings per share of a private company. In order to do an accretion/dilution analysis, one must first project the financial statements of the parent private company prior to the restructuring and then post restructuring. The results of earnings per share pre and post transactions must be compared. If earnings per share have increased, the transaction is accretive while if the earnings per share have decreased after the transaction, the transaction is dilutive. The restructuring transaction must be viewed from the standpoint of shareholder value.

Ownership Analysis

Certain types of restructuring transactions such as share repurchases, concentrate ownership among the remaining shareholders. This change in ownership will increase the earnings per-share of a private company and can imply that earnings will grow at a faster pace if a divested private company was not growing as fast as the other subsidiaries, businesses or divisions of the parent private company.

The Role of Taxes in Determining a Divestiture Approach

The tax basis to the parent private company of a potential divestiture target is an important consideration in the restructuring procedure. The higher the tax basis the more likely the asset will be divested in a direct taxable sale while a lower tax basis will be more incentives towards a tax-free alternative such as a spin-off, split-off, or equity carve-out.

Spin-Offs

A spin-off is a distribution of the stock of a subsidiary or business division to shareholders of a parent private company in proportion to their original holdings. Spin-offs are tax free transaction if they meet certain requirements with the IRS. The stock of the subordinated private company is distributed to shareholders so that the initial ownership of the spun-off private company and the parent private company is the same. However, the goal of the spin-off is to relieve the parent management from the operating and controlling responsibilities of the spun-off subsidiary.

Spin-offs have been used extensively as a method for increasing shareholder value. After extensive academic and practical research, spin-off transactions have determined to create considerable shareholder value. Specifically, returns to shareholders of private companies that spun-off unrelated businesses were higher than those of shareholders of private companies that spun of businesses related to their core. Conducted studies have reinforced the precept that the market rewards private companies for focusing on their core businesses. In addition to immediate shareholder benefits upon announcement, spin-offs provide considerable and sustainable long term benefits.

Creating Value With Spin-Offs

According to the Internal Revenue Service (IRS), creating shareholder value through spin-offs is not a valid business purpose. Even though “creating shareholder value” is not explicitly stated in spin-off agreements, spin-offs nevertheless create shareholder value indirectly for both parties. In order to visualize how a spin-off adds value to shareholders, compare the total market capitalization of the two private companies pre-spin-off and post spin-off. A small, high growth subsidiary hidden within the folds of a larger conglomerate will greatly expand in market capitalization once it is spun-off and able to secure funding for its specific needs.

A spin-off transaction deconsolidates the financial statements of the parent private company and the spun-off subsidiary. The stand alone performance of the parent and the subsidiary allows the market to value each private company individually based on operating performance and individual growth rates. Poorly performing subsidiaries that are spun-off will help the overall performance of the parent private company stock since they are not dragging down the financial statements of the parent while strongly performing subsidiaries will be valued positively by the market and shareholders will realize gains from the distribution of equity.

Balance sheets of the subsidiary and the parent will also be deconsolidated. This allows the market to asses the capital structure of each private company individually. The subsidiary will be able to finance itself using its own cost of capital. This in effect creates a more efficient use of capital for the private company’s particular needs. In addition a dividend may be paid by the spun-off private company to the parent private company. This dividend, if the spin-off meets the tax free requirements of the IRS, is also a tax free distribution to shareholders who are typically taxed on capital gains from dividends.

From the perspective of the private company’s balance sheet, a spin-off, can alter leverage ratios, earnings per share, and ownership. From the perspective of the parent private company’s income statements, spin-offs can alter the private company’s revenue growth rate, earnings per share and the multiples applied to them. In the case where a parent private company spins off a faster growing subsidiary, different multiples are applied to the spin-off and the parent private company to offset the differences in growth rates. It is also important to understand that increased shareholder value may not be realized until the market prices-in all changes within the private company.

Announcements of spin-offs signal that the parent company is focusing more on its core businesses by getting rid of poor performer or acknowledging a strong performer. The break-up of a larger private company allows for easier valuation of its parts.

Criteria For Tax-Free Dividend Payments

To be considered a tax-free dividend to shareholders, spin-offs have to meet the criteria set by Section 355 of the Internal Revenue Code:

Control – The parent must have control of the subsidiary prior to the spin-off which is considered as 80% or more of voting and non voting stock.

Active Business – Post spin-off, the parent and the subsidiary must be engaged in active trade or business that was actively conducted for five years prior to the spin-off. In addition, neither of those aforementioned businesses may have been acquired during that period in a transaction where any gain or loss was recognized.

Business Purpose – The transaction must have a concrete business purpose. Increasing shareholder value is not a valid business purpose according the IRS. Most common business purposes include focus on core business, lack of strategic fit, reduce debt, realize value of a subsidiary or regulatory reasons.

Device Test – A spin-off cannot be used as a tool to distribute earnings and profits to shareholders.

Continuity of Interest – The shareholders of the parent private company and the spun-off entity must keep a “continuity of interest” in both the parent private company and the spun-off subsidiary after the spin-off distribution is complete.

Continuity of Business – Both the parent private company and the spun-off subsidiary must continue their previous lines of business as they did pre distribution within reasonable means.

No Prior Acquisition – The parent could not have acquired this subsidiary within the past five years prior to the spin-off.

No Tax Avoidance – Governed under Section 368 of the Internal Revenue Code known for D reorganizations. As part of the tax-free status of the spin-off, the parent is unable to retain any stock in the subsidiary in an effort to avoid taxes. This clause finds its roots within the continuity of interest clause that mandates that parent private companies retain at least a 50% interest in all of their subsidiaries.

No Plan to Acquire Parent or Subsidiary – If there is an acquisition of 50% or more of the parent private company or subsidiary that was spun-off the acquiring private company will have to recognize the distribution of stock as a taxable capital gain if there was knowledge of this during the date of the spin-off.

Disqualified Distribution – If, after the distribution of stock, greater than 50% of the stock of the parent or the subsidiary is owned by a single entity or related group of parties within five years of the distribution, the distribution is disqualified of its tax free status. As a result the distribution becomes a taxable capital gain of the new parent private company. The capital gain is based off of the difference in the fair market value and the tax basis.

Issues With Respect to Spin-Offs

Section 355

Many of the sections and requirements for obtaining a tax-free spin off status through Section 355 and 368 are highly subjective and interpretations may differ. It is therefore prudent for the private company to obtain a ruling from the IRS prior to proceeding with the distribution.

Management and Governance

Although a spin-off provides incentives to management and employees, management teams, prior to the spin-off, reported to the parent private company and have no prior experience in managing the financing of a private company or managing a “new” private company as a publicly traded entity. Having no prior contact with Wall Street, the newly chosen management should not only know their business but also be trained in the differences between managing a subsidiary and a public company. The initial board of directors will be mostly comprised of the board of directors of the parent private company as they vet management, and overseeing the complete divestiture of the two private companies.

Separation of Assets

There may be significant issues in deconsolidating the assets of the parent private company and the subsidiary especially if they use the same inventory, office space or resources.

Capitalization

As the date of the distribution approaches, there may be debate over how much debt the parent private company and the subsidiary take on. It is important to understand that in large enterprises, funding and financing is allocated and obtained on the corporate level and is not always delimited per subsidiary and operating unit. As a result, the spun-off subsidiary sometimes pays a dividend to the parent private company prior to the distribution in order to delever the parent and lever up the subsidiary.

Contingent and Other Liabilities

Certain liabilities of both private companies may have been intermingled in order to take advantage of economies of scale such as 401(k) plans and health benefits. Each of the items will have to be evaluated individually so as each private company accounts for their liabilities based on underlying resources. All contingent liabilities must be resolved prior to the spin-off in order to retain the maximum benefits from the transaction.

Relations with Customers, Supplies, and Shareholders

In order to minimize investor turnover, it is important to maintain good investor relations. It is very common that after a spin-off many investors sell out of their holdings since the new spin-off or the parent private company no longer fit their investment criteria.

With similar applications to customers and suppliers, many customers and suppliers have done business with the parent or the subsidiary as a result of the other. It is important to maintain good relations throughout and post the spin-off process so as to retain all customers and suppliers.

Subsequent Events

The viability of a smaller spun-off subsidiary's strength to compete on the open market is in question as a stand alone entity, the IRS mandates that neither the parent nor the subsidiary be acquired if the transaction is to remain tax-free. Nevertheless many times within a very short while post a spin-off a subsidiary or parent are acquired and is it is only then that shareholders experience the full extent of the increased value (according to several academic studies).

Terms & Definitions

#

4 Years with a One Year Cliff

4 years with a one year cliff represents the typical vesting schedule for stock options or restricted stock (see definition), whether for startup founders' stock (if they raise Venture Capital) or for executives or employees granted Stock Options (see definition). Stock Option recipients will vest their shares over a total period of four years. The one year cliff means that the recipient will not get vested with regards to any shares until the first anniversary of the founders' stock issuance. Upon the one-year anniversary, the recipient will each vest 25% of their total stock options or shares. Vesting will then occur proportionately on a monthly after the 1-year cliff expires.

A

Accelerated Vesting

Accelerated vesting is a form of vesting that takes place at a faster rate than the initial vesting schedule in a company's stock option plan. This allows the option holder to receive the monetary benefit from the option much sooner (for example "half of all remaining unvested stock options will vest upon a Change of Control (see definition)"). Typically Accelerated Vesting applies in Change of Control situations (such as when a company is acquired or goes public.)

Acceleration Clause

An acceleration clause is a provision that allows a lender to demand payment of the total outstanding balance or demand additional collateral under certain circumstances, such as failure to make payments, bankruptcy, nonpayment of taxes on mortgaged property, or the breaking of loan covenants.

Accredited Investor

An accredited investor is an investor who is financially sophisticated and has a reduced need for the protection provided by certain government filings. Most startups or private companies prefer to raise money from accredited investors because of the vastly reduced paperwork required to be filed with the SEC, and the far fewer disclosures required to be made in writing to the investor. Accredited investors include: (1) A bank, insurance company, registered investment company, business development company, or small business investment company; (2) An employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million; (3) A charitable organization, corporation, or partnership with assets exceeding \$5 million; (4) A director, executive officer, or general partner of the company selling the securities; (5) A business in which all the equity owners are accredited investors; (6) A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase; (7) A natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or (8) A trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

Acquisition

An acquisition is the processes of taking over a controlling interest (usually 50% or more) in a company. Acquisitions can be either for stock or the assets of the target startup. Part of the purchase price may also include the Acquirer assuming debt on the company's books.

Add-On /Bolt-On Acquisition

An add-on /bolt-on acquisition is when a private equity-backed company acquires another company as a "bolt on" to enhance the private equity-backed company's value. Business jargon for a product (or company) acquisition that fits naturally within the buyer's existing business lines or strategy.

Alternative Assets

Alternative assets are any non-traditional assets with potential economic value that would not be found in a standard investment portfolio. Due to the unconventional nature of alternative assets, valuation of some of these assets can be difficult. Those asset classes outside the major mainstream classes of equities, fixed income and (usually) property where exposure is normally achieved via "bought" (long only) positions. Management of such asset classes may be active or passive. Examples include commodities, infrastructure and private equity.

Alternative Minimum Tax (AMT)

Alternative minimum tax (AMT) is a tax calculation that adds certain tax preference items back into adjusted gross income. Alternative minimum tax (AMT) uses a separate set of rules to calculate taxable income after allowed deductions. AMT is designed to prevent taxpayers from escaping their fair share of tax liability through certain tax breaks, although the structure is rife with controversy as it is not indexed to inflation or tax cuts.

Amended and Restated Articles of Incorporation

Amended and Restated Articles of Incorporation are a companies Articles of Incorporation (documents that originally formed the company) that have been later modified by the company.

Angel Investment Group

An "Angel Investment Group" is a group of wealthy individuals (often a local group, such as Boston or London) who pool their money together to make small investment in early stage private companies. (See PrivCo.com definition: "Angel.")

Angel Investor

An angel investor is a high net worth individual active in venture financing, typically participating at an early stage of growth.

Anti-Dilution Protection

Anti-dilution protection is protection from dilution when shares of stock are sold at a price per share less than the price paid by earlier investors. This is known as price-based anti-dilution protection. Anti-dilution protection, along with the liquidation preference, are two of the fundamental features distinguishing preferred stock typically sold to investors from common stock generally held by founders and employees.

Automatic Conversion

Automatic conversion is an immediate conversion of an investor's priority shares to ordinary shares at the time of a company's underwriting before an offering of its stock on an exchange.

B

Bankruptcy

Bankruptcy is a legal proceeding in which a private company's assets are used to repay outstanding debts to creditors.

Blue Sky

Blue sky are state regulations designed to protect investors against securities fraud by requiring sellers of new issues to register their offerings and provide financial details. This allows investors to base their judgments on trustworthy data.

Board Seats Demanded

Board seats demanded is the number of seats on the Board of Directors sought by an investor. Because their investments are so risky, angel and venture capital investors typically insist on being given considerable control of the company in exchange for their investment. This raises questions of loyalty and conflict of interest. VCs seek Board seats in order to protect their interests; but Board members have fiduciary obligations to promote the interests of the company as a whole, which may at times be different from the interests of the VCs.

Boilerplate

Boilerplate is the standardization of a legal document's structure and language. This leads to quicker and more efficient practices in terms of the filling out and processing of documents.

Bond

A bond is a debt investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate.

Book Value

Book value is the net asset value of a company, calculated by total assets minus intangible assets (patents, goodwill) and liabilities.

Bootstrapping

Bootstrapping is a situation in which an entrepreneur starts a company with little capital. An individual is said to be bootstrapping when he or she attempts to found and build a company from personal finances or from the operating revenues of the new company.

Break-up Fee (aka Termination Fee)

A break-up fee (also know as a termination fee) is a common fee used in takeover agreements if the seller backs out of a deal to sell to the purchaser. A breakup fee, or termination fee, is required to compensate the prospective purchaser for the time and resources used to facilitate the deal. Breakup fees are normally 1-3% of the deal's value.

Bridge Financing

Bridge Financing is a short-term loan that is used until a person or company secures permanent financing or removes an existing obligation. This type of financing allows the user to meet current obligations by providing immediate cash flow. The loans are short-term (up to one year) with relatively high interest rates and are backed by some form of collateral such as real estate or inventory.

Burn Rate

Burn rate is the rate at which a new company uses up its venture capital to finance overhead before generating positive cash flow from operations. In other words, it's a measure of negative cash flow.

Business Plan

A business plan is a written document that describes in detail how a new business is going to achieve its goals. A business plan will lay out a written plan from a marketing, financial and operational viewpoint. Sometimes a business plan is prepared for an established business that is moving in a new direction.

Buy-Sell Agreement

A buy-sell agreement is a signed agreement between an investor who is seeking to open an options account and his or her brokerage firm. This agreement is used to verify the investor's level of experience and to ensure that the investor clearly understands the various risks involved when trading options.

Bylaws

Bylaws are rules adopted by an organization in order to regulate its own affairs and the behavior of its members

C

Call Right

A call right is an agreement that gives an investor the right (but not the obligation) to buy a stock, bond, commodity, or other instrument at a specified price within a specific time period.

Capital Call

A capital call (also known as a draw down) is the legal right of an investment firm or an insurance firm to demand a portion of the money promised to it by an investor

Capitalization Table

A capitalization table (also known as a "cap table") is a table showing the total amount of the various securities issued by a firm. This typically includes the amount of investment obtained from each source and the securities distributed -- e.g. common and preferred shares, options, warrants, etc. -- and respective capitalization ratios.

Carried Interest

Carried interest is a share of any profits that the general partners of private equity and hedge funds receive as compensation, despite not contributing any initial funds. This method of compensation seeks to motivate the general partner (fund manager) to work toward improving the fund's performance.

Carveout

A carveout is a type of group term life insurance designed to appeal to well-paid executives by improving their employer-sponsored life insurance coverage. Under a group carve-out plan, the employee retains \$50,000 of ordinary group term life insurance coverage, but the rest is provided by a universal life insurance policy. The group carve-out plan replaces the current group life insurance amount over \$50,000 on the people the company wishes to carve out.

C-Corporation

A C-Corporation is a legal entity that is separate and distinct from its owners. Corporations enjoy most of the rights and responsibilities that an individual possesses; that is, a corporation has the right to enter into contracts, loan and borrow money, sue and be sued, hire employees, own assets and pay taxes

Change of Control

A change of control occurs when the ownership or Board of Directors of the company changes so materially that a different group of people or investors now control the company (often a change of more than 50% of a company's ownership is considered a change of control). Usually a change of control of a company occurs as part of an M&A transaction (see PrivCo.com definition of M&A.)

Common Stock

Common stock is security that represents ownership in a corporation. Holders of common stock exercise control by electing a board of directors and voting on corporate policy. Common stockholders are on the bottom of the priority ladder for ownership structure.

Contingency Payment

Contingency payment, in reference to a Merger & Acquisition deal, is a portion of the purchase price that depends upon the acquired company's reaching specific performance targets such as sales or profit targets.

Conversion Discount

Conversion discount is the difference between the price paid for a convertible stock and the price of the shares of common stock into which it will be converted. If the price of the convertible stock is greater than the common stock this is known as conversion discount.

Conversion Rights

Conversion rights are rights by which preferred stock "converts" into common stock. Usually, one has this right at any time after making an investment. Company may want rights to force a conversion upon an IPO; upon hitting of certain sales or earnings' targets, or upon a majority or supermajority vote of the preferred stock. Conversion rights may carry with them anti-dilution protections.

Convertible Debt

Convertible debt is security which can be exchanged for a specified amount of another, related security, at the option of the issuer and/or the holder. also called convertible.

Convertible Note

A convertible note is a debt instrument that can be converted into stock at the option of the holder or the issuer. More specifically, the investor can choose to convert the total amount of the note into equity when an institutional investor (such as a Venture Capitalist) makes an investment.

Convertible Stock

Most convertible preferred stock is exchanged at the request of the shareholder, but sometimes there is a provision that allows the company (or issuer) to force conversion. The value of convertible common stock is ultimately based on the performance (or lack thereof) of the common stock.

Corporate VC

Corporate VC is money provided by investors to startup firms and small businesses with perceived long-term growth potential. This is a very important source of funding for startups that do not have access to capital markets. It typically entails high risk for the investor, but it has the potential for above-average returns.

Co-Sale

Co-sale is a contractual obligation used to protect a minority shareholder (usually in a venture capital deal). If a majority shareholder sells his or her stake, then the minority shareholder has the right to join the transaction and sell his or her minority stake in the company.

Covenants

A covenant is a promise in an indenture, or any other formal debt agreement, that certain activities will or will not be carried out. The purpose of a covenant is to give the lender more security. Covenants can cover everything from minimum dividend payments to levels that must be maintained in working capital.

Cram Down Round

A cram down round (also known as burn-out round or wash-out round) is a common round of financing to owners of small companies that are not yet financially stable. When such financing is done, the new issuance serves to dilute drastically the ownership of previous investors and owners. Often, the new investors are able to take control of the company because the previous owners are in desperate need of more financing to avoid bankruptcy.

Creditor

A creditor is an entity (person or institution) that extends credit by giving another entity permission to borrow money if it is paid back at a later date. Creditors can be classified as either "personal" or "real". Those people who loan money to friends or family are personal creditors. Real creditors (i.e. a bank or finance company) have legal contracts with the borrower granting the lender the right to claim any of the debtor's real assets (e.g. real estate or car) if he or she fails to pay back the loan.

Cross-default

Cross-default is a provision in a bond indenture or loan agreement that puts the borrower in default if the borrower defaults on another obligation.

Cumulative Stock /Cumulative Preferred Stock

Cumulative Stock (usually Cumulative Preferred Stock) is stock that must be paid all past unpaid dividends first, before any dividends can be made to other stockholders such as Common Stock holders).

D

Deal Comparables ("Deal Comps")

Deal comparables (or "deal comps") are comparable M&A transactions used to help value a current similar M&A transaction.

Deal Flow

Deal flow is the rate at which new proposals are flowing to the underwriters of an investment bank.

Deal Multiples/M&A Ratios

Deal multiples/M&A ratios measure the value of a merger or acquisition as a multiple of the purchased company's sales, profits, or other metric. Deal multiples are used to produce "Deal Comps" (see PrivCo.com definition) in order to value other similar companies.

Debt

Debt is an amount of money borrowed by one party from another. Many corporations/individuals use debt as a method for making large purchases that they could not afford under normal circumstances. A debt arrangement gives the borrowing party permission to borrow money under the condition that it is to be paid back at a later date, usually with interest.

Debt Financing

Debt financing is when a firm raises money for working capital or capital expenditures by selling bonds, bills, or notes to individual and/or institutional investors. In return for lending the money, the individuals or institutions become creditors and receive a promise that the principal and interest on the debt will be repaid.

Debt Refinancing

Debt refinancing is the process through which a company reorganizes its debt obligations by replacing or restructuring existing debts. Refinancing may also involve issuing equity to pay off a percentage of debt. Debt is replaced or refunded by a company with money that is raised by issuing or creating other borrowing. In restructuring, a company works with its creditor to change the terms of a loan; these terms can include the reduction of interest rates, the improvement of covenants or the extension of the loan's terms.

Debtor in Possession (DIP Bankruptcy)

Debtor in possession (DIP bankruptcy) refers to a company that continues to operate while under the Chapter 11 bankruptcy process.

Delisting

Delisting is the removal of a listed security from the exchange on which it trades. Stock is removed from an exchange because the company for which the stock is issued, whether voluntarily or involuntarily, is not in compliance with the listing requirements of the exchange.

Director

A director is any member of a company's board of directors who is either an employee or stakeholder in the company.

Distressed Securities

Distressed securities are securities of companies or government entities that are either already in default, under bankruptcy protection, or in distress and heading toward such a condition. The most common distressed securities are bonds and bank debt.

Distribution

Distribution refers to when trading volume is higher than that of the previous day without any price appreciation.

Divestiture (Spin-Off)

A divestiture (also known as spin-off) is the partial or full disposal of an investment or asset through sale, exchange, closure or bankruptcy. Divestiture can be done slowly and systematically over a long period of time, or in large lots over a short time period.

Dividend

A dividend is a distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. The dividend is most often quoted in terms of the dollar amount each share receives (dividends per share). It can also be quoted in terms of a percent of the current market price, referred to as dividend yield.

Dividend Recapitalization ("Dividend Recap")

A dividend recapitalization (or "dividend recap") typically involves the company's borrowing money in order to make a large cash distribution to its shareholders. After the dividend re-cap, the company's capital structure has changed significantly (for example, it may have had no debt prior and now is debt-laden). Investors benefit by receiving a large cash distribution from the company and "taking money off the table."

Domestic Corporation

A domestic corporation is a U.S. corporation doing business in the state in which it is incorporated. A domestic corporation is the opposite of foreign corporation.

Double Trigger Acceleration

A double trigger acceleration is when two events are required to accelerate the vesting schedule of a stock option or restricted stock. Typical triggers include acquisition by another company and termination of employment without cause.

Down Round

A down round is a round of financing where investors purchase stock from a company at a lower valuation than the valuation placed upon the company by earlier investors. (Opposite: See "Up Round").

Drag Along Rights

A drag along rights is a right that enables a majority shareholder to force a minority shareholder to join in the sale of a company. The majority owner doing the dragging must give the minority shareholder the same price, terms, and conditions as any other seller.

Drawdown

A drawdown is the peak-to-trough decline during a specific record period of an investment, fund or commodity. A drawdown is usually quoted as the percentage between the peak and the trough.

Drive-By VC

Drive-by VC is a slang term referring to a deal in which a venture capitalist invests in a startup with the goal of a quick exit strategy. The VC takes little to no role in the management and monitoring of the st

Dry Close

Dry close is a type of real estate closing in which the entire closing requirements are fulfilled except the disbursement of funds. In a dry closing all involved parties agree that the closing can still happen and the funds are transferred as soon as possible following the closing. A real estate closing is the completion of a transaction involving the sale or exchange of real estate. In a traditional closing, the title to the property is transferred to the purchaser and all finances pertaining to the purchase are settled.

Due Diligence

Due diligence is an investigation or audit of a potential investment. Due diligence serves to confirm all material facts in regards to a sale. Generally, due diligence refers to the care a reasonable person should take before entering into an agreement or a transaction with another party.

E

Early Stage

Early stage is when a company has a product or service in testing or pilot production (R&D). In some cases, the product may be commercially available and may or may not be generating revenues. Early stage companies usually have been in business less than three years.

Earnout

An earnout is a portion of the purchase price that is contingent on future performance. It is payable to the seller after certain predefined levels of sales and/or income are achieved in the years after the sale. (Also see "Contingency Payment")

EBITDA

EBITDA is earnings before interest, taxes, depreciation, and amortization.

EIN

EIN is a number obtained from the IRS by filing a form SS-4. If you are a sole proprietorship, your social security number is your EIN. However, a single person LLC should obtain an EIN.

Elevator Pitch

Elevator pitch is a concise, carefully planned, and well-practiced description about your company that your mother should be able to understand in the time it would take to ride up an elevator.

Employee Stock Option Plan (ESOP)

Employee stock option plans (ESOP) are employee stock options (ESOs) that are non-standardized calls that are issued as a private contract between the employer and employee. Over the course of employment, a company generally issues vested ESOs to an employee which can be exercised at a particular price, generally the company's current stock price. Depending on the vesting schedule and the maturity of the options, the employee may elect to exercise the options at some point, obligating the company to sell the employee its stock at whatever stock price was used as the exercise price.

Engagement Letter

An engagement letter is a letter that documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the entity and the form of any reports.

Equity

Equity is a stock or any other security representing an ownership interest.

Equity Financing

Equity financing is the act of raising money for company activities by selling common or preferred stock to individual or institutional investors. In return for the money paid, shareholders receive ownership interests in the corporation.

Escrow

Escrow is a financial instrument held by a third party on behalf of the other two parties in a transaction. The funds are held by the escrow service until it receives the appropriate written or oral instructions or until obligations have been fulfilled. Securities, funds and other assets can be held in escrow.

Evergreen Fund

An "evergreen fund" is an investment fund (usually a venture capital fund) that returns any proceeds from sales of investments or dividends back to the fund rather than making distributions to its investors.

Exit

An "exit" is the term entrepreneurs, venture capitalists, private equity firms and other owners of private companies typically use to refer to an event that lets them cash out the value of their investment, ideally at a profit. An exit usually takes the form of either an IPO (during which the investor or owner can sell some or all of his securities) or in an acquisition by a larger company or by yet another private equity firm at (they hope) a higher price than they paid.

Exit Strategy

Exit strategy is the method by which a venture capitalist or business owner intends to get out of an investment that he or she has made in the past. In other words, the exit strategy is a way of "cashing out" an investment. Examples include an initial public offering (IPO) or being bought out by a larger player in the industry or a private equity firm etc. Also referred to as a "harvest strategy" or "liquidity event".

F

Fairness Opinion

A fairness opinion is a report evaluating the facts of a merger or acquisition. Fairness opinions are compiled by qualified analysts or advisors, usually of an investment bank, for key decision makers. The report examines the fairness of the offered acquisition price.

Financial Buyers

Financial buyers are acquirers of companies who are primarily investment pools such as a private equity firm or private equity fund. Financial buyers are the opposite of "strategic buyers", who are in a similar business as the company being acquires and who are doing so for strategic reasons (see PrivCo.com definition of Strategic Buyers. Financial buyers hope to profit primarily by rearranging the financial and capital structure of the acquired company (such as by taking on debt and leveraging their investment, cutting costs, and as soon as possible re-selling the company for a profit). A strategic buyer will typically incorporate the acquired company into its business operations and hold on to it for the long term, if not indefinitely.

Financing Out Clause

A financing out clause allows a potential acquirer to decline to close an acquisition—without penalty—if the potential buyer can't obtain the financing to close the acquisition.

Finder

A Finder is a (usually licensed) broker who seeks out and brings in investors into a private company. In return for his or her services, the Finder receives a "Finder's Fee", usually a percentage of the investment he brought in, either in cash or the company's stock or both, and may also include stock options or warrants in the private company (see PrivCo.com definitions of stock options and warrants.)

Finder's Fee

A finder's fee is a commission paid to an intermediary or the facilitator of a transaction. The finder's fee is rewarded because the intermediary discovered the deal and brought it forth to interested parties. Depending on the circumstance, the finder's fee can be paid by either the transaction's buyer or seller.

FINRA

FINRA is a regulatory body created after the merger of the National Association of Securities Dealers and the New York Stock Exchange's regulation committee. The Financial Industry Regulatory Authority is responsible for governing business between brokers, dealers and the investing public. By consolidating these two regulators, FINRA aims to eliminate regulatory overlap and cost inefficiencies.

First Time Fund

A first time fund is an initial private equity fund raised by a newly established firm. First-time funds are marketed to prospective limited partners using investment team performance figures from prior firm transactions or funds.

Flat Round

A flat round" is a round of financing (usually venture capital financing) where investors purchase stock from a private company at the same valuation as the valuation placed upon the company by earlier investors. (Also see PrivCo.com definitions of "Up Round" and "Down Round").

Follow-on Financing

Follow-on financing is a subsequent private equity fund established after the investment period of a prior fund.

Foreign Qualification

A foreign qualification registers a company to transact business in another state or multiple states.

Founder

A founder is a person who initially establishes a new enterprise, venture, or has an idea for one and assumes the greatest amount of accountability for the project.

Founders' Shares

Founders' Shares are shares held (or originally held) by the founders of a company. They may be golden shares, deferred shares, have other characteristics that distinguish them from ordinary shares. In some contexts founders' shares may simply mean ordinary shares held by the founders.

Free Cash Flow (FCF)

Free cash flow (FCF) yield is a measure of value that investors often look at to determine the potential return on investment.

Friends and Family Round

A friends and family round occurs at the start up of a new company. Often the first place they look for seed financing is from friends and family. As frequently as they occur, there is very little available on the details of what consists of a "good" friends and family financing.

Full Ratchet

Full ratchet is an anti-dilution provision that, for any shares of common stock sold by a company after the issuing of an option (or convertible security), applies the lowest sale price as being the adjusted option price or conversion ratio for existing shareholders.

Fully-Diluted Basis

Fully-diluted basis is the total number of shares that would be outstanding if all possible sources of conversion, such as convertible bonds and stock options, were exercised. Companies often release specific financial figures in terms of fully diluted shares outstanding (such as the company's profits reported on a fully diluted per share basis) to allow investors the ability to properly assess the company's financial situation.

Fund

A fund is the investment vehicle where limited partners have committed capital.

Fund of Funds

A fund of funds is a private equity fund that invests in multiple private equity funds. Fund-of-funds are set-up to diversify investor money across funds with different strategies or operating in different geographies. These funds also leverage relationships and provide access to well-established private equity funds that may otherwise not be open to smaller investors. Fund-of-funds promoters layer in an additional fee on top of the fees already associated with the funds being invested in.

Funding Round / Series

Funding round/series is the amount of money needed to fund the ongoing operations or future development of a business or project that is currently provided by cash, equity or debt.

G

General Partner

General Partner is the manager of an investment partnership. (PE Firms)

Golden Share

A golden share is a type of share that gives its shareholder veto power over changes to the company's charter.

Go-Shop

Go-shop is a provision that allows a public company that is being sold to seek out competing offers even after it has already received a firm purchase offer. The original offer then functions as a floor for possible better offers. The duration of a go-shop period is usually about one to two months. Go-shop agreements may give the initial bidder the opportunity to match any better offer the company receives, and may pay the initial bidder a termination fee if target companies are purchased by another firm.

Grants

Grants are the issuance of an award, such as a stock option, to key employees under a stock plan. A stock option grants the employee the right to purchase a certain number of shares of the company's stock at a predetermined price. There is usually a waiting period before an employee can exercise their stock options.

Grossing Up

Grossing up is a practice usually in reference to an employer reimbursing a worker for the taxes paid on some portion of their income, usually from a one-time payment such as relocation expenses. In other words, if an employee is promised \$5,000 for relocation expenses, the actual check might be issued for \$6,500. This would leave the promised \$5,000 after the required taxes had been deducted.

Growth Stage

The growth stage is the third state in a product's life cycle where sales revenue rises rapidly and the profits reach a peak. Thereafter, the decline stage begins.

H

Haircut

Haircut is difference between the market value of a collateralized asset and the amount of loan advanced against it. See also loan value.

Hedge Fund

A hedge fund is an exceptionally risky and largely unregulated US investment partnership which employs aggressive leverage to multiply gains (or losses) from fluctuations in the prices of financial instruments (bonds, notes, securities). Hedge funds are restricted under US law to less than 100 investors who typically put in a minimum of one million dollars each.

Hockey Stick

Hockey stick is an anti-competitive bidding practice in which a market participant (or trader) offers an extremely high price for a small portion of a good. (The name derives from the price curve of this practice, which resembles a hockey stick.)

Holding Company

A holding company is a parent corporation that owns enough voting stock in another corporation to control its board of directors (and, therefore, controls its policies and management).

Holding Period

A holding period is the real or expected period of time during which an investment is attributable to a particular investor. In a long position, holding period refers to the time between an asset's purchase and its sale. In a short sale, the holding period is the time between when a short seller initially borrows an asset from a brokerage, and when he or she sells it back. In other words, the length of time for which the short position is held.

Hurdle Rate

A hurdle rate is the minimum amount of return that a person requires before they will make an investment in something.

I

Incentive Stock Option (ISO)

Incentive Stock Option (ISO) is a type of employee stock option with a tax benefit, when you exercise, of not having to pay ordinary income tax. Instead, the options are taxed at a capital gains rate.

Incorporation

Incorporation is the process of legally declaring a corporate entity as separate from its owners.

Incubator

An incubator is a firm engaged in the business of fostering early-stage companies through the developmental phases until such time as the company has sufficient financial, human and physical resources to function on its own.

Indemnification

Indemnification is the process of securing an agreement between two parties to compensate for any damages or losses.

Indemnity

Indemnity is a contractual agreement made between different parties to compensate for any damages or losses.

Information Rights

Information rights are rights (usually a clause in a venture capital investment agreement) that an investor has to demand to receive regular updates from the private company about its financials and operations.

Initial Public Offering (IPO)

An initial public offering (IPO) is the first offering of a firm's stock (shares) on the stock market, at the time it 'goes public.' Because a stock market usually values the stock on the expectations of the firm's future growth and income, IPO's are typically an opportunity for the founders and other early investors to make high profits by cashing their stockholdings.

In-kind Distribution

In-kind distribution is a distribution made in the form of stock rather than cash. This type of distribution occurs when cash is not readily available or allocating stock is the better alternative. An example would be a stock dividend.

Institutional Investor

An institutional investor is a non-bank person or organization that trades securities in large enough share quantities or dollar amounts that they qualify for preferential treatment and lower commissions. Institutional investors face fewer protective regulations because it is assumed that they are more knowledgeable and better able to protect themselves.

Integration

Integration is when a company expands its business into areas that are at different points of the same production path.

Intellectual Property (IP)

Intellectual Property (IP) is a broad categorical description for the set of intangibles owned and legally protected by a company from outside use or implementation without consent and can consist of patents, trade secrets, copyrights and trademarks, or simply ideas. The concept of intellectual property relates to the fact that certain products of human intellect should be afforded the same protective rights that apply to physical property. Most developed economies have legal measures in place to protect both forms of property.

Internal Rate of Return (IRR)

Internal Rate of Return (IRR) is the discount rate often used in capital budgeting that makes the net present value of all cash flows from a particular project equal to zero. Generally speaking, the higher a project's internal rate of return, the more desirable it is to undertake the project. As such, IRR can be used to rank several prospective projects a firm is considering. Assuming all other factors are equal among the various projects, the project with the highest IRR would probably be considered the best and undertaken first. IRR is sometimes referred to as "economic rate of return (ERR)".

Invention Assignment

An invention assignment is a legal document that acknowledges all intellectual property developed by a co-founder or developer is property of the company and not the individual.

Investment Advisor

An investment advisor is any person or group that makes investment recommendations or conducts securities analysis in return for a fee, whether through direct management of client assets or via written publications. An investment advisor who has sufficient assets to be registered with the SEC is known as a Registered Investment Advisor, or RIA. Investment advisors are prohibited from disseminating advice known to be deceitful or fraudulent and from acting as a principal on their own accounts by buying and selling securities between themselves and a client without prior written consent.

Investor Rights Agreement

An investor rights agreement is a venture capitalist typically expects to get the following rights associated with an investment, which are often contained in an Investor Rights Agreement: (1) The right to elect one or more directors to the company's board of directors; (2) The right to receive various reports, financial statements, and information; (3) The right to have its stock registered for sale in a public offering at the company's cost; (4) The right to maintain its percentage share ownership in the company by participating in future stock issuances; (5) The right to participate in the sale of any shares made by the founders of the company (a so-called "co-sale" right which is embodied in a separate agreement)

IPO Participation Rights

IPO participation rights are often sought by pre-IPO venture capitalist investors in order to take advantage of escalating first day trading prices when the company conducts an initial public offering. These participation rights, whether in the form of a firm option or a best efforts undertaking, grant the recipient the right to purchase shares offered in the company's IPO on the same terms as other IPO participants.

Issued Shares

Issued shares is the number of authorized shares that is sold to and held by the shareholders of a company, regardless of whether they are insiders, institutional investors or the general public.

Issuer

An issuer is a legal entity that develops, registers and sells securities for the purpose of financing its operations. Issuers may be domestic or foreign governments, corporations or investment trusts. Issuers are legally responsible for the obligations of the issue and for reporting financial conditions, material developments and any other operational activities as required by the regulations of their jurisdictions. The most common types of securities issued are common and preferred stocks, bonds, notes, debentures, bills and derivatives.

J

J Curve

J-curve is a type of diagram where the curve falls at the outset and eventually rises to a point higher than the starting point, suggesting the letter J. While a J-curve can apply to data in a variety of fields, such as medicine and political science, the J-curve effect is most notable in both economics and private equity funds; after a certain policy or investment is made, an initial loss is followed by a significant gain.

Junior Debt

Junior debt is debt that is either unsecured or has a lower priority than of another debt claim on the same asset or property. Junior debt is lower in repayment priority than other debts in the event of the issuer's default. Junior debt is usually an unsecured form of debt, meaning there is no collateral behind the debt.

Junk Bond

A junk bond is a bond rated 'BB' or lower because of its high default risk. Also known as a "high-yield bond" or "speculative bond".

L

Late Stage / Late Stage Company

A "Late Stage" company is one that has already has established customers, revenues, and business model. A "Late Stage Investment" is an investment in a Late Stage company.

Late Stage Investment

A "Late Stage Investment" is an investment in a Late Stage company (see PrivCo.com definition of "Late Stage").

Later Stage Financing

Later stage financing is the type of financing that is awarded to a start-up company by a venture capital firm when the company's product or service becomes widely available. Financially, the company is generating strong revenues and likely has positive cash flow. It may or may not be profitable. Companies receiving later-stage financing may include spinouts of operating divisions of existing private companies.

LBO "Love Letter"

An LBO "Love Letter" is a slang term used in private equity and M&A circles that refers to a letter sent by a prospective private equity buyer (usually to a public company's Board) offering to enter into negotiations to acquire the target company through a leveraged buyout (LBO). An LBO Love Letter may also be sent to a private company. LBO Love Letters typically are sent to companies who previously were not actively seeking to sell themselves. (For example, KKR used a Love Letter in 2010 to first approach Del Monte Foods, and eventually led to KKR's taking Del Monte Foods private through a leveraged buyout / LBO.) Upon receipt of an LBO Love Letter, a company's Board of Directors has a decision to make, and often leads the Board to hire investment bankers to provide advice on the company's strategic options, including a formal M&A process or agreeing to a period of exclusive negotiation with the private equity firm that approached it. In doing so, an LBO Love Letter can put the company "in play" and attract rival suitors and M&A bids.

Lead Investor

A lead investor is a company's principal provider of capital, such as the entity which originates and structures a syndicated deal.

Legal Opinion

A legal opinion is a legal opinion published in a case is of special interest, or if there is something unusual about the ruling. For example, if a judge sets a precedent, challenges an existing law, or provides a novel interpretation of the law, the legal opinion would be published. Likewise, legal opinions from high courts, in which judges are called upon to interpret very complex legal challenges, are usually published.

Letter of Intent

A letter of intent is a letter from one company to another acknowledging a willingness and ability to do business. A letter of intent is most often issued as acknowledgment of the fact that a merger between companies or an acquisition is being considered seriously. Sometimes, a letter of intent may also be issued by a mutual fund shareholder to indicate that he/she would like to invest certain amounts of money at certain specified times. In exchange for signing a letter of intent, the shareholder would often qualify for reduced sales charges. A letter of intent is not a contract and cannot be enforced, it is just a document stating serious intent to carry out certain business activities.

Leverage

Leverage is the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment. Leverage is the amount of debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged. Leverage is most commonly used in real estate transactions through the use of mortgages to purchase a home.

Leveraged Buyout (LBO)

A leveraged buyout (LBO) is the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

License

A license is a legal document that entitles the holder of it authorization to exercise a specified right or rights.

Lifestyle Company

Lifestyle company is a lifestyle business in which an entrepreneur often supplies the starting capital, which may include "borrowing" funds from family or a bank. Often a lifestyle business will be a smaller business such as franchise or retail shop, or a service business of some type. Typically the business is owned by the operator or a small partnership and does not have a lot of independent outside investors.

Limited Liability Company (LLC)

A limited liability company (LLC) is a form of corporate structure and ownership for a private company in which the private company's shareholders are protected from liability (as with a corporation or an "Inc.") but is taxed like a partnership (also known as "pass through" taxation) where the private company doesn't pay income taxes directly. At the end of each tax year, the LLC send its shareholders a form showing the shareholder's share of the private company and the shareholder's share of the LLC's profits, losses and equity balance.

Limited Liability Partnership (LLP)

A limited liability partnership (LLP) is two or more partners united to conduct a business jointly, and in which one or more of the partners is liable only to the extent of the amount of money that partner has invested. Limited partners do not receive dividends, but enjoy direct access to the flow of income and expenses.

Limited Partner (LP)

In a limited partnership (see PrivCo.com Definition: Limited Partnership) limited partners are those who are passive investors and who don't actively participate in the partnership's decisions, but who receive distributions of dividends and profits from the partnership. In the private company world covered by PrivCo.com, a limited partner (aka an "LP") usually refers to an investor in a private equity fund, while the general partner is the private equity firm (that is, the investment management company who decides which companies to acquire and who then oversee management of its "portfolio companies"). For example, if XY Private Equity Partners forms XY Equity Partners Fund II, that fund's investors (such as wealthy individuals, pension funds, and university endowments) are the limited partners (or "LPs"), and XY Private Equity Partners, who manages the Fund, is the Fund's general partner and makes the investment decisions (See also PrivCo.com Private Company Knowledge Bank section on Private Equity Funds.)

Limited Partnership

A limited partnership is a business organization with one or more general partners and one or more limited partners (see PrivCo.com definition of limited partner). The general partners in the limited partnership actively manage the business and assume the legal debts and obligations, while the limited partners are typically passive investors who are liable only to the extent of their investments and who receive a share of distributions from the partnership. In the private company world covered by PrivCo.com, limited partners usually refer to the investors in a private equity fund, while the general partner is the private equity firm (that is, the investment management company who decides which companies to acquire and who then oversee management of its "portfolio companies"). For example, if XY Private Equity Partners forms XY Equity Partners Fund II, that fund's investors (such as wealthy individuals, pension funds, and university endowments) are the limited partners (or "LPs"), and XY Private Equity Partners, who manages the Fund, is the Fund's general partner and makes the investment decisions (See also PrivCo.com Private Company Knowledge Bank section on Private Equity Funds.)

Line of Credit

A line of credit is an arrangement between a financial institution, usually a bank, and a customer that establishes a maximum loan balance that the bank will permit the borrower to maintain. The borrower can draw down on the line of credit at any time, as long as he or she does not exceed the maximum set in the agreement.

Liquidation Preference

Liquidation preference is a term used in venture capital contracts to specify which investors get paid first and how much they get paid in the event of a liquidation event such as the sale of the company. Liquidation preference helps protect venture capitalists from losing money by making sure they get their initial investments back before other parties. If the company is sold at a profit, liquidation preference can also help them be first in line to claim part of the profits. Venture capitalists are usually repaid before holders of common stock and before the company's original owners and employees. Many times the liquidation preference can even be a "2x" or "3x" liquidation preference: that is, the venture capitalists first must receive 2 or 3x their original investment before all stockholders (including the VCs) in the private company start sharing the proceeds of a sale equally.

Liquidity Event/Exit Event

A liquidity event (also known as an exit or exit event) is a term that describes several possible events that allow initial investors of a company to cash out a portion or all of their investment. A liquidity event can take place in the form of an IPO or a merger/acquisition with/by another company.

Lock-up Period

A lock-up period is a window of time in which investors of a hedge fund or other closely-held investment vehicle are not allowed to redeem or sell shares. The lock-up period helps portfolio managers avoid liquidity problems while capital is put to work in sometimes illiquid investments.

LP Units

LP Units is an ownership unit in a publicly traded limited partnership, or master limited partnership (MLP). This trust gives the unit holder a stake in the income generated by the partnership company. A MLP often distributes all available cash flow from operations to unit holders after the deduction of maintenance capital.

M

Management Buy-Out (MBO)

A management buy-out (MBO) is when the managers and/or executives of a company purchase controlling interest in a company from existing shareholders.

Management Fee

A management fee is a charge levied by an investment manager for managing an investment fund. The management fee is intended to compensate the managers for their time and expertise. It can also include other items such as investor relations expenses and the administration costs of the fund.

Management Rights

Management rights is a range of discretion in managing an organization reserved for its management under most corporate legislation. Management rights comprise of core rights (such as to determine the organization's mission, budget, strategy) and operational rights (such as to assign, direct, hire and fire).

Market Capitalization

Market capitalization is an on-going market valuation of a public firm (whose shares are publicly traded) computed by multiplying the number of outstanding shares (held by the shareholders) with the current per share market price. It is, however, not necessarily the price a buyer would pay for the entire firm. Market capitalization is not a realistic estimate of the firm's actual size, because a share's market price is based on trading in only a fraction of the firm's total outstanding shares.

Material Adverse Change Clause

A material adverse change clause is a contingency legal provision often found in mergers and acquisitions contracts and venture financing agreements that enables the acquirer (or funder) to refuse to complete the acquisition or merger or financing with the party being acquired (often termed, the "target") if the target suffers such a change.

Merger

A merger is the combining of two or more companies, generally by offering the stockholders of one company securities in the acquiring company in exchange for the surrender of their stock

Merger Agreement

A merger agreement is a contract governing the merger of two or more companies

Mergers and Acquisitions (M&A)

Mergers and acquisitions (M&A) is a general term used to refer to the consolidation of companies. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

MergerSub

A "MergerSub" is the term given in M&A documents of a new shell company formed by the Acquirer solely to complete its acquisition of a target company. In this M&A structure, the Acquirer: (1) first creates a new entity such as an LLC that is a shell company (the "MergerSub") that is a subsidiary of the acquirer; (2) the MergerSub then enters into a merger agreement with the acquired company; (3) afterward the acquired company is no longer an independent company but is owned by MergerSub, which in turn is owned by Acquirer. Thus after the transaction, the acquired company is effectively owned by the Acquirer.

Mezzanine Financing

Mezzanine financing is a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. Mezzanine financing is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

Middle-Market Firms

A middle-market firm is a firm with sizeable annual revenues, ranging from \$50 million to \$1 billion. As the term implies, such a firm is one that straddles the "middle market" between the smaller companies and the billion-dollar giants. In the case of professions such as legal, accounting and brokerage, middle market firms are those that are just below the dominant firms (such as the Big Four in accounting) in their respective field.

Mid-Stage / Mid-Stage Investment

A "Mid-Stage" company is one that has already has established customers, revenues, and business model, but has not yet grown large or mature enough to be considered "late stage" (See PrivCo.com Definitions of "Late Stage" and "Early Stage". A Mid-Stage investment is an investment in a Mid-Stage company.

Milestones

Milestones is a term used within the framework of project management. A milestone is the end of a stage that marks the completion of a work package or phase, typically marked by a high level event such as completion, endorsement or signing of a deliverable, document or a high level review meeting.

N

Narrow-Based Weighted Average

A narrow-based weighted average is an anti-dilution provision used to ensure that investors are not penalized when companies are undergoing additional financing or issuing new shares. A narrow-based weighted average takes into account only the total number of outstanding preferred shares for determining the new weighted average price for the old shares.

Net Income

Net income is a company's total earnings (or profit). Net income is calculated by taking revenues and adjusting for the cost of doing business, depreciation, interest, taxes and other expenses. This number is found on a company's income statement and is an important measure of how profitable the company is over a period of time. The measure is also used to calculate earnings per share.

NewCo

The term "NewCo" is usually put into Merger and Acquisition Documents as a generic name for a new company that the M&A transaction will create. Example: "After the merger, XY Capital Partners will then invest \$50 million into NewCo."

NewSub

The term "NewSub" is usually put into Merger and Acquisition Documents as a generic name for a new subsidiary company that the M&A transaction will create, which will become a subsidiary of the acquirer. Example: "After the merger, Microsoft will then invest \$50 million into NewSub."

Non-compete Clause

A non-compete clause or covenant not to compete (CNC), is a term used in contract law under which one party (usually an employee) agrees not to pursue a similar profession or trade in competition against another party (usually the employer).

Non-Cumulative Dividends

Non-cumulative dividends is a type of preferred stock that does not pay the holder any unpaid or omitted dividends. If the corporation chooses to not pay dividends in a given year, the investor does not have the right to claim any of those forgone dividends in the future.

Non-disclosure Agreement (NDA)

A non-disclosure agreement (NDA) is a legal contract between two or more parties that signifies a confidential relationship exists between the parties involved. The confidential relationship often will refer to information that is to be shared between the parties but should not be made available to the general public.

Non-Participating Stock

Non-participating stock (usually non-participating preferred stock) is stock that has no right to be paid the company's dividends.

Non-Qualified Stock Option (NSO)

Non-qualified stock option (NSO) is a type of employee stock option where you pay ordinary income tax on the difference between the grant price and the price at which you exercise the option.

Non-Solicitation

Non-solicitation is an agreement that restricts an individual (usually a former employee) from soliciting either (a) employees or (b) customers of a business after leaving the business.

No-Shop Clause

A no-shop clause is a clause preventing the owner of the target company from attempting to sell the business to someone else while the two named parties are negotiating. The no-shop provision is good for a set period of time, such as 60 days, negotiated between the parties.

O

Officer

An officer is a person who is a position of authority at a company.

OldCo

The term "OldCo" is usually put into Merger and Acquisition documents as a generic name for the acquired company's current legal name, which is expected to disappear after the M&A transaction. For example: "As contemplated in this acquisition, Microsoft will form Soft Holdings. After the transaction OldCo will cease to exist as a separate entity."

Option Pool

An option pool is shares of stock reserved for employees of a private company. The option pool is a way of attracting talented employees to a startup company if the employees help the company do well enough to go public, they will be compensated with stock. Employees who get into the startup early will usually receive a greater percentage of the option pool than employees who arrive later.

Ordinary Income Tax

Ordinary income tax is income received that is taxed at the highest rates, or ordinary income rates. Ordinary income is composed mainly of wages, salaries, commissions and interest income (as from bonds). Ordinary income can only be offset with standard tax deductions, while capital gains income can only be offset with capital losses.

Outstanding Shares

Outstanding shares is the stock currently held by investors, including restricted shares owned by the company's officers and insiders, as well as those held by the public. Shares that have been repurchased by the company are not considered outstanding stock. Also referred to as "issued and outstanding" if all repurchased shares have been retired.

Overhang

Overhang is a measure of the potential dilution to which a common stock's existing shareholders are exposed due to the potential that stock-based compensation will be awarded to executives, directors or key employees of the company. It is usually represented in percentage form and is calculated as stock options granted, plus the remaining options that have yet to be granted divided by the total shares outstanding.

Oversubscription

Oversubscription is a privilege provided to existing shareholders in a company when the company issues a rights or warrants offering. This enables shareholders to "subscribe" to purchase extra shares that are not picked up by the remaining shareholders.

Over-the-Counter Market (OTC)

Over-the-counter market (OTC) is a decentralized market of securities not listed on an exchange where market participants trade over the telephone, facsimile or electronic network instead of a physical trading floor. There is no central exchange or meeting place for this market.

Ownership Stake

Ownership stake is a share of ownership in a company by its founders.

P

Par Value

Par value is the face value of a bond.

Pari Passu

Pari passu is two securities or obligations having equal rights to payment.

Participating Dividends

Participating dividends is a type of preferred stock that gives the holder the right to receive dividends equal to the normally specified rate that preferred dividends receive as well as an additional dividend based on some predetermined condition. The additional dividend paid to preferred shareholders is commonly structured to be paid only if the amount of dividends that common shareholders receive exceeds a specified per-share amount.

Participating Stock

Participating stock (usually "participating preferred stock") is stock that is entitled to receive the company's dividend payments.

Pass Through Entity

A pass through entity is a legal business entity that passes income on to the owners and/or investors. Flow-through entities are a common device used to limit taxation by avoiding double taxation. Only the investors/owners are taxed on revenues, not the entity itself.

Pay to Play

Pay to play is a phrase used for a variety of situations in which money is exchanged for services or the privilege to engage (play) in certain activities.

Payment in Kind (PIK)

Payment in kind (PIK) is the use of a good or service as payment, instead of cash. Also known as "paid in-kind."

Piggy-Back Rights

Piggy-back rights is a form of registration rights that grants the investor the right to register his or her unregistered stock when either the company or another investor initiates a registration. This type of registration right is seen as inferior to demand registration rights, because this class of right-holders cannot initiate the registration process.

Pitchbook

A pitchbook is a presentation (usually in PowerPoint format) prepared by an investment banking firm or other middle-man that provides an overview to potential investors of the opportunities of the investment, such as a proposed M&A deal. The term is also used to refer to the presentation an investment banking firm gives to a potential client (for example, a private company considering potential acquisitions or an IPO) as part of a "beauty contest" where the potential client company is listening to presentations ("pitches") from several investment banks before selecting one to handle the transaction.

Placement Agent

A placement agent is an individual or company that assists entrepreneurs or private companies in looking for a private equity investment or new capital via private placement.

Plan of Reorganization

Plan of reorganization is a plan for reorganizing the operations of a company that is in bankruptcy. A plan of reorganization is a proposal to lift the company out of bankruptcy and may be voted on by the creditors of the company.

Portfolio Company

A portfolio company is a company in which a venture capital or a private equity firm. For example, if XY Venture Partners invests in PrivCo, PrivCo would be a "portfolio company" of XY Venture Capital Partners.

Post-Money Valuation

Post-money valuation is the value of a company directly after an equity investment in the company is made, i.e. pre-money valuation plus the equity investment amount.

Preemptive Right

A preemptive right is the right to acquire certain property or securities before any other person. Preemptive right generally refers to the right of shareholders to buy a new issuance of stock before it is offered to external investors so that their ownership is not diluted.

Preferred Stock

Preferred stock is a specific class of stock that has a higher claim on assets and earnings than common stock. Preferred shares, depending on the issuing company, have characteristics akin to both debt and equity, having both potential appreciation and fixed payments. Dividends on preferred stock are paid before the dividends on common stock.

Pre-Money Valuation

Pre-money valuation is the value of a company just before an equity investment in the company is made. The valuation is agreed upon between investors preparing to participate in a new funding round and the company. It is used to determine the price per share to be paid by investors in the new funding round (subscription price).

Pre-Rumor Premium

In an acquisition, the pre-rumor purchase premium is the amount paid per-share of a public company being acquired or taken-private that is over the amount the stock had been trading at on the public markets before reports of the acquisition began to leak in the press. For example, if an acquisition of XY Corp. is announced at \$24 a share and it had previously been trading at \$20 a share on the date the acquisition is formally announced, but XY Corp. stock had been trading at \$12 per share before reports about the possible acquisition began to leak in press reports, the pre-rumor premium is 100%. (See also PrivCo.com definition of "Purchase Premium")

Private Company

A private company is a company or corporation whose ownership is private. A private company does not have to meet the Securities and Exchange Commission filing requirements of public companies. Private companies issue stock and have shareholders but their shares do not trade on public exchanges and are not issued to the general public. A private company is treated as a single legal entity with rights and liabilities separate from its owners. Owners and other private investors are shareholders in the private company.

Private Equity

Private equity is an individual or consortium of investors and funds that make investments directly into private companies or initiate buyouts of public companies. Private equity is ownership in private companies that is not listed or traded on public exchanges. This is considered an illiquid and long-term investment.

Private Offering

A private offering is an investment offer into a private company to a select or small group of investors by the company management to raise capital.

Private Placement

Private placement is a capital raising method that sells securities of a private company to institutional or accredited investors. Private placements do not require filing with the Securities and Exchange Commission and detailed financial information is not disclosed. Private placements are offered to a small number of investors and are usually a direct sale of securities between the issuer and the investor. Note that a private placement can also be done by a public company. For example, a public firm may do a private placement to issue new bonds, which is the typical case of large "private placements."

Private Placement Memorandum

A private placement memorandum is a prospectus detailing the type of securities offered, objectives, risks, and terms of the private placement. A typical private placement memorandum includes a detailed business description, financial statements, and management biographies.

PrivCo

The term "PrivCo" is usually put into Merger and Acquisition Documents as a generic name for a private company being acquired (or who is doing the acquiring) as part of the M&A transaction. For example: "Intel Corporation will then acquire PrivCo for total consideration of \$10,000,000 in cash and 10,000 shares of Intel Corp." (Of course this is also the trademark for PrivCo.com, the leading financial data provider on private companies.)

Pro Rata

Pro rata (directly defined as proportionately or in proportion) refers to the allocation of materials or resources to multiple holders based on a proportional scale of ownership

Promote

Promote is a marketing/advertising action to encourage sales, the advancement of rank or position and the encouragement of progress or action.

Prospectus

Prospectus is a formal document detailing an offer to sell securities to the public. A prospectus is filed with the Securities and Exchange Commission and offers information regarding investment objectives, policies, risks, and depending on the product, potential fees and services. Key selected financial data and management profiles are also included in a prospectus.

Public Company

A "public company" is a company whose stock (equity) securities are publicly traded on an exchange such as the New York Stock Exchange, NASDAQ, London Stock Exchange, etc.

Public Offering

A public offering is the initial sale of stock by a private company to the public, called an offering or a flotation. A public offering is usually done with the help of a syndicate of underwriters and arrangers who distribute the initial shares to their brokers and high net worth clients.

Purchase Agreement

A purchase agreement is a contract that obligates the buyer to buy and the seller to sell. A binding legal document that establishes the terms of the agreement, including the sale price, the terms of the sale, and the actual item for sale.

Purchase Premium

In an acquisition, the purchase premium is the amount paid per-share of a public company being acquired or taken-private that is over the amount the stock had been trading at on the public markets before the announcement of the acquisition. For example, if an acquisition of XY Corp. is announced at \$24 a share and it had previously been trading at \$20 a share, the purchase premium is 20%. (See also PrivCo.com definition of "Pre-Rumor Premium")

Put Right

A "put right" is the right of a stockholder to sell his stock back to the company who sold it to him ("put" it back to the company") at a fixed price.

Q**Qualified Financing**

Qualified financing is equity financing for a start-up for the purpose of raising funding. Qualified financing provisions are often specified in convertible notes to determine investment thresholds required for the automatic conversion of a note into equity.

Quiet Period

Quiet period is regulation by the Securities and Exchange Commission that restricts promotional publicity of a security up to 3 months post its IPO.

R

Ratchet / Full Ratchet

A ratchet provision (usually a "Full-Ratchet" provisions) provides anti-dilution protection to an investor (see PrivCo.com definition of "anti-dilution"). When a company raises new equity capital such as venture capital, with a Full Ratchet provision an investor has the option of having his or her percentage ownership remain the same as his initial investment. For example, an investor who paid \$10 per share for a 20% stake in a private company would get more shares in order to maintain that stake if a subsequent round of financing were to come through at \$8 per share. (This is known as a "down round

see PrivCo.com definition of Down Round.") The earlier round investor would have the right to convert his shares at the \$8 per share price as part of the Down Round, increasing his shares by 25% and maintaining his 20% ownership stake in the private company.

Recapitalization

Recapitalization is the restricting of a company's debt and equity mixture in order to stabilize the corporate capital structure, diversify the debt-to-equity ratio, defend against a hostile takeover, and minimize tax obligations or to implement an exit strategy for venture capitalists.

Redemption

Redemption is return of the investor's principal in a fixed income security. A fixed income security can be redeemed at par, at a premium/discount, upon maturity or at a callable date. There may be certain limitations that exist such as minimum holding periods prior to redemption.

Redlining

Redlining typically refers to marking up a document during the negotiations of a transaction such as a venture capital deal, merger, acquisition, buyout etc. (The marked up document is referred to as the "redline", as in "I've sent over the redline".)

Registered Agent

A registered agent is a person or company that is designated to receive all important information and documents on behalf of the corporation. A registered agent must be available at all times at a designated legal address.

Registrable Securities

Registrable securities are shares of common stock issuable to holders of preferred stock upon conversion of the shares.

Registration

Registration is the process of filing documents with the Securities and Exchange Commission detailing the specifics of a proposed public offering. Registration includes detailed information on the filing company's assets, operations, company management, and the offered securities. Registration also includes third-party audited financial statements.

Registration Rights

Registration rights is a contractual right allowing holders of restricted stock to petition the issuing company to register the shares with the Securities and Exchange Commission in order to put the shares up for sale.

Reincorporation Merger

A reincorporation merger is a merger agreement which merges an existing company that is registered in a certain location and under a certain name with a legal entity, which may be registered in a different location and possibly under a different name. The purpose of the merger agreement is to alter the name or the registered location of an existing corporation to benefit from certain rules and business regulations that are not located in the state of original incorporation.

Reporting Company

A "reporting company" is a company that is required to file financial disclosure documents with the Securities and Exchange Commission (SEC). These can be public companies, or can be private companies who have some securities such as bonds that were sold to the public and remain publicly-traded.

Representations and Warranties ("Reps and Warranties")

Representations and Warranties (also referred to as "reps and warranties") are the claims a seller of a company is making to the acquirer (such as "We have no outstanding litigation"; "The attached financial statements are accurate" etc.

Repurchase Option

A repurchase option is a right granted to a third party by an vested options holder to repurchase his shares at a nominal price prior to the shares vestation.

Restricted Stock

Restricted stock is shares owned by insiders of a company that are under a sales restriction for a specified period of time.

Restricted Stock Purchase Agreement

A restricted stock purchase agreement is a legal document made between the shareholder and the startup company that details the transfer and purchase of stock by the shareholder, its price, amount, and restrictions placed on the sale of the stock through a vesting schedule.

Restructuring

Restructuring is a modification made to the operations, structure or debt of a company to put in a more favorable business position and remove financial harm such as overbearing debt payments.

Return on Investment

Return on investment is a performance measure used to calculate and compare the efficiency of different investments. Calculation involves finding the difference between the gain on an investment and the cost of the investment as a percentage of the cost of the investment.

Revenue

Revenue is the total amount of money a company receives for its sales and services prior to expenses, taxes, amortization and depreciation. Revenue is calculated by multiplying the price at which goods are sold by the amount of goods sold. Revenue figures can differ based on inventory accounting methods such as "Last In First Out" or "First In First Out."

Reverse Break Up Fee (Reverse Termination Fee)

A reverse break up fee is a termination fee an acquiring company pays to the target company in a merger or acquisition transaction if the acquiring company terminates or backs out of the transaction.

Reverse Merger (Reverse Takeover)

A reverse merger (reverse takeover) is a type of merger transaction used by private companies to become publicly traded without an initial public offering. A reverse merger is initiated when a private company purchases a controlling interest in a public company. The shareholders of the private company then exchange their shares in the private company for shares in the public company and thereby effectively becoming a publicly traded company.

Reverse Vesting

Reverse vesting is a vesting schedule offered by pre-IPO companies. Under the agreement, stock options may be exercised immediately after they are granted in exchange for restricted shares in a company that have separate vesting schedules. Reverse vesting is used as a tax-planning technique when used in combination with Section 83(b) of the Internal Revenue Code.

Right of First Refusal

Right of first refusal is a contractual obligation by an owner of an asset to offer the initial purchase option to the holder of the rights prior to offering the asset for sale to third parties. The right of a party to purchase an asset before it is made available for purchase to others.

Rights Offering

Rights offering is an offer for existing shareholders of a company to purchase additional securities at a given price (usually at a discount) for a fixed time-frame.

Road Show

A "road show" is a presentation by an issuing company to market its offered securities (typically through an IPO) to potential buyers or investors. The term "road show" is derived from the fact that the company's management, chaperoned by their investment bankers, usually make stops in several major cities over a couple week period where investors can sit in on the presentation and decide whether to buy the stock (See PrivCo.com definition of "IPO".)

Rollup

Rollup is the exchange of one option position for another with a higher strike price. This often occurs when a venture capital firm forces smaller companies to merge in order to reduce costs.

Round

A "Round" (also known as a "Funding Round" or "VC Round") is an investment made in a private company by one or more investors using a particular set of terms, usually but not always closing on the same date. There can be one or multiple participants in a round, and all generally have the exact same price and other terms (for example a private company's "B Round" might be its second venture capital round involving 3 VC firms for a total of \$9 million with each firm contributing a piece of the round; the company's "Series B" stock issued to all 3 VC firms will all have the same price, and terms and conditions such as liquidation preferences (see PrivCo.com definition), whether the stock is participating preferred (see PrivCo.com definition), receives dividends etc. The round's investors may also be represented as a group with a seat on the private company's board (see PrivCo.com definition of "board seats demanded").

Royalties

Royalties are payments made to the owner of an asset for use of that asset.

S

S Corporation

An S-Corporation is a form of a corporation that allows companies that have less than 100 shareholders to benefit from the liability protection of a corporation and the tax benefits of a partnership. This means that the earnings of the company are only taxed once at the personal income level. A company that meets the requirements to be taxed under the Internal Revenue Code Subchapter S.

Scalability

Scalability is the capability of a system, function, or model to maintain and even improve performance under continuously greater operational demands without changing its core infrastructure.

Scale Down

Scale down is to reduce the size of something in proportion to its other components.

Scale Up

Scale up is to increase the size of something in proportion to its other components.

Search Fund

Search fund is a tool used by entrepreneurs to raise funds from investors in making private equity investments.

SEC Filing

An SEC filing is a required formal document submitted to the U.S. Securities and Exchange Commission (SEC), thus making it available to the public through the SEC's online database. The document often includes a financial statement that details the company's financial performance. Publicly traded companies are required to make regular SEC filings.

SEC Form 10-K

Form 10-K is the name of the Securities and Exchange Commission form on which a public company (or private company with publicly traded debt) must file its Annual Report making full disclosure to investors of its financial position, income statement, business operations etc. Any company required to file reports with the SEC (known as a "reporting company") must file a 10-K every fiscal year.

SEC Form 10-Q

Form 10-Q is the name of the Securities and Exchange Commission form on which a public company (or private company with publicly traded debt) must file its Quarterly Report making full disclosure to investors of its financial position, income statement, business operations etc. Any company that is required to file reports with the SEC (known as a "reporting company") must file a 10-Q at the end of each quarter.

SEC Form 8-K

Form 8-K is the name of the Securities and Exchange Commission form on which a public company (or private company with publicly traded debt) must file to disclose any significant change or event to investors. Examples of events that require an 8-K Form to be filed are: a merger or acquisition, bankruptcy, departure of key executive, or notice of delisting. The SEC requires an 8-K be filed within four days of the occurrence of the event.

SEC Form D

Form D is the name of the Securities and Exchange Commission form that is required to be filed by a private company using an exemption under Regulation D when selling its securities to investors. Under Regulation D, a private company does not have to register its securities and does not have to file reports with the SEC and thus not have to disclose its financial position. The company must file a Form D after they first sell their securities. Form D consists of a brief notice that includes the names and addresses of the company's executive officers and stock promoters, but contains little other information about the company.

SEC Form S-1

Form S-1 is the name of the Securities and Exchange Commission that is required to be filed by a company before an initial public offering (IPO) of securities. The form requires full disclosure to investors of its financial position, income statement, business operations etc., as well as a complete description of the security being offered and terms of the sale.

Second Lien Debt

Second lien debt is a debt that is subordinate to the rights of other senior debt issued against the same collateral. If a borrower defaults on the debt, second lien debt has a lower claim on payments from the underlying collateral than the higher lien debt.

Second Stage Funding

Second stage funding is venture capital funding stage at which an idea has most likely been transformed into a product and is now competing with the rest of the market. The goal of second stage funding is to obtain market share and minimize loss as the company tries to reach a break-even point.

Secondary Sale/Secondary Buy-out

A secondary sale (also known as a secondary buy-out) is a type of leveraged buyout where one private equity firm sells its stake in a company to another private equity firm thereby fully exiting from its investment.

Section 363 Bankruptcy Sale

A section 363 Bankruptcy sale is a sale of assets in a bankruptcy case, usually in a Chapter 11 reorganization. An expedited auction of a bankrupt company where buyers are able to purchase assets free of any liens. Liens on the underlying assets sold will be reattached to the proceed of the sale and paid accordingly. Section 363 sales do not require shareholder approval.

Secured Debt

Secured debt is debt that is backed or secured by an underlying asset, which is considered collateral. Collateral is used to reduce the risk associated with lending.

Securities Exchange Act of 1934

The Securities Exchange Act of 1934 is an act passed to form a governing body of laws to regulate securities transactions after they are issued, broker-dealers, and exchanges in order to protect the interests of the investing public. The Securities and Exchange Commission was formed to enforce the laws passed by the act.

Securitization Facility

Securitization facility is tool used to pool various types of existing debt and repackaging them as bonds and selling the new debt obligations to investors. This enables the issuer to consolidate their debt obligations into a single issuance and simultaneously pay off all previous debt holders.

Security

A security is a tradable, negotiable financial instrument representing value. A security can be categorized as debt securities such as bonds, bank notes, and debentures or equity securities such as common stock, derivative contracts, forwards, futures, options and swaps.

Security Interest

Security interest is a legal claim offered by the borrower of loan which provides the lender with an interest in certain assets which they can claim if the debt obligation is not met.

Seed Capital/Seed Funding

Seed capital (also known as seed funding) is the initial capital used to start a business. Seed capital usually comes from the founder's personal assets or investments by friends and family, but can also come from outside angel investors. Since the venture is usually in the conceptual stage, seed capital is used to sponsor research and development and cover basic expenses until the product or services can begin generating revenue.

Seed Stage

Seed stage is the stage at which a business has no customers and has not yet fully developed its business model. During this stage, a company may still need to conduct research and development to further establish commercial operations.

Senior Debt

Senior debt is a bond or other form of debt that holds priority over other debt issued by the borrowing company. In the event of bankruptcy, senior debt must be repaid before any other creditors receive payment.

Series / Series A / Series B etc.

A "Series" such as Series A, Series B, Series C etc. is an investment Round (see PrivCo.com definition of "Round") where all the investors invest on the same set of terms, such as price, dividend and liquidation preference rights etc. Most of the time all the investors present their investments at approximately the same time, and the Round "closes" on a fixed date for all investors. (This is not always the case as sometimes late investors can "get in on the Round" on the same terms a few months later.) The Series letters are just in order of the investment rounds, the first Round being Series A, the second round being Series B, third round being Series C, fourth round being Series D, and so on.

Series A Preferred Stock

Series A preferred stock is stock issued by a company during the seed or other early stage round of financing. A preferred stock is usually convertible into common stock in such cases as an IPO or the sale of a company.

Series A Round

Series A round (or "Series") is the first round of financing after the seed round which is usually the first time the company opens up to external investors. At the point of a Series A round of financing, companies may be generating little or no revenue from operations. Investors are typically venture capital funds and angel investors.

Series AA Round

Series AA round is an angel or seed round of start-up financing that issues a class of preferred stock.

Series B Round

Series B round is the second round of financing for a business by private equity investors or venture capitalists following the initial seed and series A round. Series B funding is generally takes place after the company has achieved certain milestones in its business development.

Shareholder Consent

Shareholder consent is permission granted by a stockholder in a company for the company to take certain actions (such as raise for capital, or enter into an M&A transaction). Private company investors often demand that shareholder consent be obtained for certain major transactions or actions before the private company can make them.

Shareholders Agreement

The shareholders agreement is a document that governs the relationship between the startup company and the shareholders. The agreement details the rights of the shareholder with regards to first refusal, transfer rights, and redemption rights.

Shell Corporation

A shell corporation is a corporation that has operations or assets. Shell corporations are usually formed prior to beginning business operations to obtain financing. Historically, shell corporations have been used as a method of tax evasion.

Single Trigger Acceleration

Single trigger acceleration is a clause in the vesting agreement that shortens the vesting schedule by a pre-designated time after a single event occurs such as a acquisition by another company.

Small Business Investment Company (SBIC)

A small business investment company (SBIC) is a privately owned and Small Business Administration licensed company that profits on its investments in small firms. SBICs have access to federal funding that matches the available credit for a company based on the size of its investments.

Sources and Uses of Funds

"Sources and Uses of Funds" is a restriction placed on an investment into a private company by the investor. For example, the investor's contract may demand that the Sources and Uses of Funds are to be to make acquisitions, or only to purchase a particular piece of real estate such as a factory. Often Sources and Uses of Funds will be very loose and say that the Sources and Uses is "for general corporate purposes".

Spinoff

A spin-off is the creation of an independent company by the issuance of new shares by an existing business division of a company. A spin-off is a type of divestiture where a company that wishes to streamline its business will sell less productive or unrelated subsidiaries as spin-offs.

Startup

A startup is a company that is in its first stage of operations, has small or no market-share and is financed by its founders or select investors and venture capital firms.

Stock Options

Stock options is the benefit a company gives its employees to purchase the company's stock at a discounted or fixed price at some point in the future. Stock options are used as incentives to retain talented employees by offering them performance based payouts especially of the price the option can be exercised at is considerably lower than the current price of the stock.

Stock Plan

A stock plan is an agreement that allows employees and executives of companies to own a share of the company via stock options, employee ownership, and restricted stock issuance as a form of compensation.

Stock Purchase Agreement

A stock purchase agreement is a legal document made between a shareholder and a startup company that details the transfer and sale of the startup's stock to the share holder. The agreement discloses the amount of shares purchased, share price, and payment method.

Stock Split

A stock split is a corporate action in which a company's existing shares are divided into multiple shares. The total dollar value of the shares does not change because earnings per share remain proportional to pre-split levels. Stock splits do not add any value to shareholder's equity but make share transactions more liquid since the price is more manageable for small investors.

Stockholder's Equity

Stockholder's equity is the section of the balance sheet that lists the capital received from investors in exchange for stock and the retained earnings of a company.

Stockholders

A stockholders is any person, company or legal entity that owns a share of another company.

Strategic Buyers

Strategic buyers are acquirers of companies who are in a similar line of business as the acquired company, and are entering into a merger or acquisition (M&A) transaction for strategic reasons, such as expanding into a new geographic market, increasing existing market share, or adding an innovative new technology. Strategic buyers can also benefit from reducing overlapping overhead costs such as Human Resources, Finance, and others and make the combined new entity more profitable. Strategic buyers are the opposite of "financial buyers" (see PrivCo.com definition of "Financial Buyers"), who are investment funds who hope to profit primarily by rearranging the financial and capital structure of the acquired company (such as by taking on debt and leveraging their investment, cutting costs, and as soon as possible re-selling the company for a shorter term profit). A strategic buyer will typically incorporate the acquired company into its business operations and hold on to it for the long term, if not indefinitely.

Strategic Investment

A strategic investment is an investment by a corporation or an affiliated firm into a young company that has potential to offer something of value in return or will create synergy with the existing business of the investor.

Subordinated Debt

Subordinated debt is a security that ranks below other securities when it comes to claim on assets or earnings. In case of bankruptcy, subordinated debt does not get repaid until all senior debt has been settled.

Subscription Price

Subscription price is a price at which shareholders can participate in a follow on offering conducted by a public company so they may retain their proportional ownership of the business. Subscription price can also be defined as the exercise price for warrant holders in a particular stock.

Subsidiary

A subsidiary is a company where the controlling interest of voting stock (greater than 50%) is owned by another company, referred to as the parent company.

Supermajority Voting

Supermajority voting is a corporate amendment requiring a greater majority (usually 67-90%) of stakeholders to approve important changes.

Surviving Corporation

A surviving corporation is the company in the merger or acquisition transaction that acquires the targets assets and continues the operations of the preceding company. The surviving company may be a newly organized legal entity or an existing one.

Sweat Equity

Sweat equity is ownership interest given in return for contributions of time, labor and other non-capital efforts.

Syndication

A syndication is a group of accredited or institutional investors who combine funds to help a company finance the entirety of their project and to delegate the risk of the transaction among all syndicate members.

T**Tag Along Right**

Tag along right is a contractual obligation to protect the rights of a minority shareholder in illiquid deals. If the majority stakeholder decides to sell their stake, a minority stake holder is allowed to "tag-along" in the transaction and sell their stake as well. Also referred to as "co-sale rights."

Take Private

A take private is the action of purchasing a public company's outstanding shares and de-listing the company from a publicly traded exchange in an effort to take the company under private ownership.

Takeover

A takeover is a change in the controlling interest of a company via sale, merger, or buyout. A purchase of a company (labeled Target company) by an acquirer. Usually in reference to an acquisition of public company by a private company.

Target / Deal Multiples

Target / deal multiples is a factor used to multiply a business economic benefit to derive the business value. Multiples are used to evaluate business value using comparable company data.

Target Company

A target company is the company to be acquired or that was acquired.

Technology Transfer Agreement

A technology transfer agreement is a purchasing agreement for the rights to own, utilize, and possibly produce technology that was previously owned by another.

Ten Bagger

A ten bagger is an investment term coined by Peter Lynch where the investment is sold for more than ten-times more than its original purchase price.

Term Sheet

A term sheet is a list of specifications and requests outlining the material terms and conditions of a contract. A term sheet may include a time-line.

Tranche

Tranche is a portion of a security offered in a transaction that has distinct risk specifications and maturity dates than the other layers of the multiple-class security.

U

Underwater

Underwater is the condition of a call option where the strike price is above the market price and conversely a condition of a put option where the strike price is below the market price. Also known as "out of the money."

Unsecured Debt

Unsecured debt is a debt that is not guaranteed by an underlying asset or collateral therefore offered by lenders at generally higher interest rates that are based off the credit rating of the borrower.

Up Round

An "up round" is a round of financing where investors purchase stock from a company at a higher valuation than the valuation placed upon the company by earlier investors. An "up round" is the opposite of a "down round". (See PrivCo.com definition for "Down Round").

V

Valuation

Valuation is a method of determining the current worth of an asset or company; an appraisal of value using various techniques which include analysis of financial statements, management profiles, competitive space, industry, and markets.



Venture Capital

Venture capital is capital provided by investors to small business and start-up firms that have potential high growth opportunities. Venture capital investments have a potential for considerable loss or profit and is generally designated for new and speculative enterprises who seek to generate a return through a potential initial public offering or sale of the company.

Venture Capital Limited Partnership

A venture capital limited partnership is a limited partnership of funds and angel investors which is formed to invest in small start-up businesses

Venture-Backed Company

A venture-backed company is a private company whose investors include a venture capital firm. (See PrivCo.com definition of "Venture Capital".

Vesting Schedules

A vesting schedule is a schedule detailing the time frame and the extent to which stock options may be exercised or awarded.

Voting Rights

Voting rights is the right of a stock holder to vote on matters of company policy such as stock issuances, corporate actions, operational changes, and mergers. The number of votes a shareholder is entitled to corresponds to the number of shares they own.

W**Warrant**

A warrant is a derivative security that gives the holder an option to purchase securities from the issuer at a specific price within a designated time frame.

White Label

White label is the act of rebranding a service or product produced by one company. The rebranding company usually overlays their own customized brand name or visual appeal on the product and markets it as their own. The original product is actually owned by the manufacturer.



PrivCo Media, LLC

19 W 21st Street, Suite 1105

New York, NY 10010

T: 212-645-1686

F: 646-304-1193