Shareholder dilemma: what stake to offer to financial investors? Reflection based on financial principles

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Abstract

Companies in their growth stage often require sums of money that exceed their operating cash flows. A need for raising funds might be associated with entering new markets, expanding production, acquiring other businesses. Debt and equity are the two main sources of capital available to businesses and each have advantages and limitations.

A sale of ownership stakes to private equity funds and other financial investors is an attractive alternative as far as it does not increase leverage and leads to competitive advantages achieved thanks to expertise and access to capital markets provided by the investor.

Private equity financing requires business owners to find their way solving a number of questions, including a choice between a strategic, financial and operational investor as well as making a decision on a stake offered to him.

The major aim of the paper is to create a notion based on the corporate experience outlining the ability to identify the size of shareholding capital that is a subject of offer to the financial invertors.

Keywords: private equity, financial investors, stake offered to investors.

In the course of its development, a growing company faces a need for external financing for realizing its investment programs.

Various sources of financing are available. Two basic types of funding are debt financing and equity financing. The debt financing options might be limited: bank loans are only available to firms with good credit history and mature sales. Moreover, some business owners feel uncomfortable dealing with banks and deliberately avoid this option. Attracting a financial investor who is eager to provide financing in exchange for a share in business can be considered as a reasonable alternative.

Types of investors

Generally, there are two types of investors distinguished, namely they are financial and strategic investors. The major distinction between them is the following. Strategic investors besides economic viability are concerned with a strategic potential of a purchase and tend to accept offers not less than a controlling interest. By contrast, financial investors supply firms with capital and they are aimed at exiting the business as soon as feasible, usually in 5-7 years earning annually not less than 25% return on invested capital.

Financial investors act as providers of sources both operating expenditures (OPEX) and capital expenditures (CAPEX). Primarily financial investors are focused on getting return on their investments. The most important indication of success for them is the price of their shares. The major driver of investment decisions of financial investor is the expectations of the exponential growth of the business within 3-5 years. Financial investors are motivated by capitalization increase and receiving dividends while holding a share. Usually financial investors require the following company's characteristics: consistent earnings, reasonably high growth rates, effective CEO and management team. They are always on the lookout, searching for willing buyers for their stake. The stock exchange is a common exit strategy.

In its turn a strategic investor is predominantly oriented on long-term investment horizons. They are conserened with a business model itself and its improvement. In the frame of this article we assume that strategic investors do not have speculative intentions and actively participate in managing a business aiming at revenue growth.

Alongside with financial and strategic investors we suggest introducing a notion of operational investors. How can an operational investor contribute to a business? His input may include base of clients, distributors and suppliers with beneficial business conditions, administrative resources. These market players invest in a target company achieving the growth of it as well as the growth of their core businesses. Thus, a target company is an instrument for stimulating growth of the core business that an operational investor holds. However he works on achieving synergy at companies that has aroused his interest.

In this article we describe aspects of business valuation and try to find the way to identify a share that can be offered to a financial investor. Strategic and operational investors are irrelevant for the objectives of this research as far as the owners of fast-growing businesses are often reluctant to attract strategic investors because shareholders are not willing to go out of their business.

Literature review and Methodology

The Methodological framework and approach was mainly based on the interviews with representatives from FMCG industries equally from the Corporate business side and real financial investors moved on to the shareholding capital. We base on 22 interviews used as a base for our research. Together with that we used case method describing financial calculations and the solutions for the stake size definition to financial investor offering through WACC calculation, FCF, Equity value and Equity cost definition. Basically we took real executed deals.

Attracting a financial investor is an effective tool for increasing business value. Exit strategies have a significant influence on business value and risk to owners of a business. Compared to strategic investors, financial investors are more conservative with respect to the business valuation (Zakharov, 2010). Due to the concentration on achievement of financial goals (high return on investment), and the possible lack of industry experience financial investors are not aimed at acquiring a controlling interest in business. One of the reasons for that is the risk avoidance. Most likely financial investor will not be able to manage the business as efficiently as acting team of managers or owners. However, as a rule, a financial investor is interested in getting a share is not less than the blocking.

From the risks point of view the group of financial investors is not heterogeneous. Researchers (Weidig, Mathonet, 2004) stays that each type of private equity investment vehicle has a different risk profile. A direct investment has a total loss probability of 30%. A fund or a portfolio of direct investments has a very small probability of total loss. A portfolio of funds has a small probability of any loss.

In our research private equity funds takes a core place as financial investors. Financial mass media calls private equity funds as “new kings of Wall Street”. These financial investors deal with a wide range of business entities from startups to large corporations.

Significantly, private equity funds provide not only the initial capitalization for companies, but management and operational advice as well (Black, Gilson, 1998). Almost all private equity funds are set as limited partnerships, with private equity firms operating as a general partner (GP) of the funds, and big institutional investors and wealthy individuals providing capital as limited partners (LPs)or passive investors (Harris, 1998). The structure of the relationship between these investors and their fund managers set the base for potential several for investors to monitor an allocation of their investments. Interests of managers and investors often differ. On the one hand investors require managers to use their expertise to maximize the value of their investments. On the other hand, fund managers intuitively might want to shrink responsibility, and hide information or redirect resources for their own benefits. Thus an agent problem is created.

According to researchers, decisions of private equity funds are based on the market timing theory. Ljungqvist and Richardson (Ljungqvist, Richardson 2003) link the timing of funds’ investment to exit decisions, and the returns they earn on portfolio companies, to shifts in the demand for private equity. Following this logic, when investment opportunities improve and the demand for capital increases existing funds accelerate their investment flows and earn higher returns. Rises in supply lead to more intense competition for deals, and private equity fund respond by shrinking their investment programs.

Liquidity of securities may be a parameter that researchers associate with private equity decision-making process. Lerner and Schoar (Lerner, Schoar, 2004) present a model in which a private equity firm chooses the degree of illiquidity of shares to screen for investors with long horizons. The idea of the model is driven by the information asymmetry between inside and outside investors. Illiquidity is approached as a choice variable, which can be influenced by the manager of the fund and allows him to screen for deep-pocket investors. Low liquidity would not scare away long-term investors, but investors who expect to face many liquidity shocks in the future would find these restrictions irrelevant and therefore would avoid investing. The benefits of having liquid investors become apparent once the firm has to go back to the market to raise new capital.

A number of studies are dedicated to an issue of investment attractiveness of a business. Methodology of Valinurova and Kazakova (Valinurova, Kazakova, 2005) suggests considering fifty-five parameters characterizing an enterprise. These parameters determine the cumulative investment potential and investment risk and then an integral index of investment attractiveness of the business is calculated.

For identifying company's investment attractiveness there has been developed a number of concepts, including the three-factor model (Sizykh, 2012), which allows to evaluate the investment attractiveness with regard to the preferences of investors in three areas: profitability, risk and corporate governance. Sevryugin’s Methodology (Sevryughin, 2004) evaluates the following indicators of investment attractiveness of enterprises of different organizational forms: financial position, corporate governance and market environment. Financial position of a company is considered by some researchers (Kuznetsov et al, 2004, Krylov et al, 2003) as a core of a set company’s investment attractiveness factors. Among the factors of investment attractiveness of an enterprise researchers also take into account the corporate governance practices, relations with the regions, and a role in the social division of labor (Doroshin, 2005).

Our experience in dealing with financial investors and the literature review have allowed us to create a test that determines the willingness of financial investors to consider business as an investment target.

A sign, that financial investors may be interested in a company is a positive response to the following three questions:

Question 1. Is an exit strategy clear for an investor?

Analysis of an investment target usually begins with an assessment of prospects for exiting the business (exit strategy). A private equity fund analyzes recent transactions in the industry, paying attention to exit ways of financial investors. Even if there are few or no deals, at the moment of entering the business the fund should clearly see an option for making a successful IPO or sale of a share to a strategic investor.

Question 2. Are the business and business model sustainable and scalable?

Revenue model and the model of the company's profits should be understandable. Lack of ability to multiply (being reused in different environment) the business model, even if it is stable; make the business unattractive for financial investors.

Question 3. Is a management team professional, and whether it has a strong motivation for achieving an exponential business growth?

The managing team need not only to prove its willingness to develop and implement a business strategy, but also be able to find new opportunities emerging in the market and launch new projects.

However, in our literature review we have not found an answer to the question of how an owner can determine the share offered to investors. Further, on the hypothetical example we consider a situation that often occurs in practice, and suggest recommendations.

What stake to offer?

According to a definition provided by International Private Equity and Venture Capital Valuation Guidelines, a fair value is the price that would be received to sell an asset in transaction between market participants at the measurement date.

In order to identify a share to offer, it is important to understand a need in external financing and identify a fair value of equity at a day of negotiations.

Often business owners include into valuation assessment of future investment projects. However, since there is likelihood that investment projects can be launched later, or not implemented at all, the projects can be viewed as call option out of the money (OTM) and, therefore, they have an extremely low price today. Thus, firstly it is important to valuate the business "As It Is", and then take into account the investment projects.

Business valuation "As It Is" allows us to correctly identify a share offered to an investor while business valuation with projects enables an investor see gains in investment projects implementation.

Business valuation "As It Is"

Suppose you are a food products manufacturer, and in 2013 you received the following financial indicators:

- Revenue – 600 million rubles.,
- profitability EBIT - 8%
- required working capital - 10% of revenue,
- loans and borrowings - 100 million rubles.,
- income tax rate - 20%.

For annual growth of 10-12% you need net investment (capital expenditures minus depreciation) that amount to 4% of the revenue. You expect that by 2018, due to internal improvements the EBIT margin can be increased up to 10%. Then, the cash flow will be as follows (Table 1):

Table 1. Cash flow forecast

Million Rubles	2013	2014	2015	2016	2017	2018
Revenue	600,0	660,0	726,0	798,6	878,5	966,3
Growth rate		*10%*	*10%*	*10%*	*10%*	*10%*
EBIT	48,0	55,2	63,5	73,0	84,0	96,6
Profitability EBIT	*8,0%*	*8,4%*	*8,7%*	*9,1%*	*9,6%*	*10,0%*
EBIT after tax		44,2	50,8	58,4	67,2	77,3
Required working capital	60,0	66,0	72,6	79,9	87,8	96,6
Changes in required working capital		-6,0	-6,6	-7,3	-8,0	-8,8
Investments		-26,4	-29,0	-31,9	-35,1	-38,7
Free Cash Flow		**11,8**	**15,2**	**19,2**	**24,1**	**29,9**

If the weighted average cost of capital (WACC) equals 18% and exit multiple is 7x EBIT, then the value of the business is 384 million rubles., the cost of equity is estimated as 284 million rubles. (Table 2).

Table 2. Calculating the cost of equity

Discount factor		0,92	0,78	0,66	0,56	0,47
Discounted FCFF		10,8	11,8	12,7	13,5	14,2
Terminal value						676,4
Disounted terminal value						321,2
Equity value (EV)	**384,2**					
Loans and borrowings	-100,0					
Cost of equity	**284,2**					

Business valuation with investment projects

Suppose the market provides good growth prospects. If the net investment in business the next two years will amount to 200 million rubles, then from 2016 to 2018, we can expect an annual revenue growth of 45%, and by 2018, EBIT margin of 12% with a projected 8.7 % in 2015. Then the company's cash flow will be following (Table 3):

Table 3. Cash flows forecast with investment projects

Million Rubles	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Revenue	600,0	660,0	726,0	1052,7	1526,4	2213,3
Growth rate		*10%*	*10%*	*45%*	*45%*	*45%*
EBIT	48,0	55,2	63,5	102,3	164,8	265,6
Profitability EBIT	*8,00%*	*8,37%*	*8,75%*	*9,72%*	*10,80%*	*12,00%*
EBIT after tax		44,2	50,8	81,9	131,9	212,5
Required working capital	60,0	66,0	72,6	105,3	152,6	221,3
Changes in required working capital		-6,0	-6,6	-32,7	-47,4	-68,7
Investments		-126,4	-129,0	-42,1	-61,1	-88,5
Free cash flow to the firm (FCFF)		**-88,2**	**-84,8**	**7,1**	**23,4**	**55,3**

Using the described valuation assumptions (WACC=18%, exit multiple=7), then the business value will be 779 million rubles, and cost of equity will be 679 million., ie implementation of the investment program will increase the value of the business by 395 million rubles. (Table 4).

Table 4. Calculating the cost of equity with investment projects

Discount factor		0,92	0,78	0,66	0,56	0,47
Discounted FCFF		-81,2	-66,2	4,7	13,1	26,2
Terminal value						1859,2
Discounted terminal value						882,8
Equity value (EV)	**779,4**					
Loans and borrowings	-100,0					
Cost of equity	**679,4**					

What minority stake to offer to an investor?

In practice, share will be determined at the negotiations and will largely depend on the balance of forces during them, but if we approach financial investors with an offer of 29% (the necessary investments, divided by the cost of equity with investment projects), such an offer be rejected immediately. The main reason for that is the following. The cost of equity of 679 million rubles we get if a financial investor invests 200 million rubles. Without 100% investment equity share will worth 284 million rubles. Thus, the financial investor should be offered a stake of 41% (the necessary investments, divided by the sum of the cost of equity and the investments required).

As far as the value of a privately held company is subjective category, a share offered to a financial investor (assuming that the forecasted free cash flows accepted by an investor) depends on two factors: risk assessment (WACC) and the exit multiple.

A sensitivity analysis shows the following. If a financial investor believes that the risks in the business are higher than we describe, therefore value the company, using WACC of 20% and the exit multiple of 5 times EBIT in 2018, he will begin negotiations with the controlling stake, namely 54%, as shown in the table below (Table 5). In such scenario, an investor valuates 100% of the equity without investment projects as 173 million rubles.

Table 5.

		Exit multiple				
		5	**6**	**7**	**8**	**9**
WACC	16%	48%	43%	39%	36%	33%
	17%	50%	44%	40%	37%	34%
	18%	51%	46%	41%	38%	35%
	19%	52%	47%	42%	39%	36%
	20%	54%	48%	44%	40%	37%

Conclusion

Both debt and equity financing are important sources of capital for business enabling it to fund its operations. Deciding which to use or increase depends on the long-term goals of the business and the amount of control shareholders willing to maintain. Private equity financing and financial investors are the center of attention of this research paper.

In this article, we have described types and motives of investors while acquiring equity interests in a business and proposed solely financial argumentation for calculating the share offered to investors.

Major result of the presented research is the concept for finding a size of a share offered the on the basis of financial calculations. This brings us to a recommendation to offer investors a share based not on “feeling”, but on a solid basis of a particular method built on financial principles.

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