GUEST

MVision's Paula Chester *points to ten things in private placement memoranda that will keep investors from reaching for their guns.*

No-nos in your PPM

What is it about a private placement memorandum (PPM) that will make it stand out from all of the others in the pile stacked on the investor's desk – besides, of course, the hot pink colour?

The primary challenge facing a general partner preparing a PPM is to create a document that provides a sufficient amount of information to make the potential investor interested and want to delve further, while, at the same time, recognising that it is, first and foremost, a marketing document.

But the PPM, while a marketing document, is also a legal document. We all know that there are serious obligations under the prevailing securities laws. In the US, the GP is essentially required by The Securities Act of 1934 not to lie about, or omit to state, a material fact that would otherwise be required to make the statements made not misleading. So, while there is a defined set of precepts that guide the fund offering, one must also find the best way to convey the important elements that differentiate one investment opportunity from the rest. Regulation D presumes a level of sophistication and accredited investors are presumed to be able to ask for the information they need to make a judgment on whether or not to invest. That lets the GP tell the story in a way that both informs and sells at that the same time. So the PPM need not include everything about the fund, e.g. more information will always be provided. While it may mark the beginning of the decision-making process, it is definitely not the end of it.

Nevertheless, how does a GP convey the message without either boring investors or driving them crazy? There are industry practices that have evolved that dictate what must be in a PPM. Consequently, what drives investors to throw a PPM in the trash – the investment professionals' equivalent of "reaching for their guns" – is usually not what information is missing, but how certain content is presented.

INVESTMENT STRATEGY

1. *Actual case studies are better than fiction*. Hypothetical studies just don't quite make it when describing an investment strategy. Quite frankly, it is increasingly difficult to clearly differentiate one buyout strategy from another. Most GPs want to back strong managers; so what else is new? The best way, however, is to clearly articulate a defined strategy followed by case studies that demonstrate the implementation of the strategy in a portfolio company. The hypothetical example of what you would do if you had $500 million is the equivalent of me saying that with the South Beach diet, a personal trainer and a good haircut, I could be Halle Berry.

2. *Tell all*. This is one of my favorites. The Executive Summary tells a story of good returns in the aggregate, but neglects to mention the lopsided returns in a small group of investments which drive the overall numbers. This may not be the worst thing in a seed/early stage venture capital portfolio, but in a growth equity or LBO portfolio? What's going on? A-ha! We learn deep in the bowels of the PPM that the GP has determined to focus on those industries or strategies that have created those hefty returns, while abandoning those strategies which have not worked: just like a few good men, a few good deals can make the overall portfolio look a lot better. Okay. The GP's going to have to face that discovery, like it or not. But don't you just hate to read 50 pages only to find out that what you see in Portfolio X is not what you get in Portfolio X, plus lots of bad deals! If there's been a shift in strategy from the old portfolio, you better face that up front—don't keep the investor guessing.

3. *Present loan deals as lessons learned*. It seems that every day we make mistakes and, at the same time, learn something new. So why can't GPs face up to their lessons learned? An investor wants to know what went right and what went wrong: lessons learned for the next portfolio and procedures in place to avoid future faux pas. Incorporating those lessons into the historical memory of the firm seems pretty important.

Investors will be pretty unforgiving if it's basically ignored in the PPM.

DEAL SOURCING CAPABILITY

4. *Be specific about how you source deals.* Saying that they do not participate in auctions or that all their deal flow is proprietary is insufficient to describe what is distinguishable about your deal flow. Let's face it, how many exceptional club deals have been originated by multiple individuals? Be proactive in describing the sourcing capability. And by the way, these days, a lot of good deals have been run through some limited competitive process – how else can sellers test whether they are getting a fair price for their company? – so if they were, say so.

INVESTMENT PROCESS

5. *Give a reasonable amount of detail.* Describe the levels of review, how deals are staffed and the investment decision at each level of the process. GPs without a process need not apply.

6. *Focus on the important bits.* Everybody meets on Monday mornings these days. The level of detail presented at these meetings is not necessary in a PPM. So, a description of the whole team getting together to discuss each deal is, quite frankly, overdone. And, it is not a good substitute for being able to back up the process with examples of real deals with a real paper trail. Everyone loves a good story, but investment pros need the detail.

INDUSTRY EXPERTS ON YOUR TEAM

7. *Explain why they're there.* Ten years ago, who would have thought that the private equity industry would have become a retirement alternative for former senior executives? It's a good idea given that for most firms, these executives can provide an additional network to generate deal flow and a level of operational detail that the GPs may lack to adequately perform due diligence on a target company or work out the problems of a troubled portfolio business. But providing a description of their illustrious backgrounds without describing why they are important to the GP's business model begs the point. Why have these experienced executives on board when you are unclear as to how and why they are important to your organisation?

8. *Who does what?* In a time when operational efficiency has become ever more important as top line growth for certain industries becomes more complex and difficult to achieve, investors need to understand how the limited resources of any firm are being allocated to analyse and implement the necessary organisational improvements and operational changes. Let's face it – most buyout shops are relatively small in terms of numbers of personnel. When third party consulting firms provide access to these specialised skills-sets to augment a teams' talents, don't leave this critical component vaguely discussed, or worse, unmentioned.

TRACK RECORD

9. *Remember: investors hate searching for the numbers.* There are 50 potential fund investments a month to review and consider. Investors are investors, not archeologists. PPMs that do not include gross IRRs by company broken down at a minimum by realised and unrealised investments in the portfolio will not be taken seriously. And another thing: quite often aggregate numbers are presented in an "Executive Summary" with the fuller detail by company in the back. But aggregate IRRs that do not provide the investor with the amount of invested capital or the number of companies in each category of realised and unrealised portfolio investments (or at least a per cent figure for each) just make it more difficult for everybody. It's the only way the reader can figure out the likelihood of the GP maintaining those great realised returns over their entire investment life. Why make everyone guess right from the start?

10. *Tell them what the numbers mean.* The disclosure of the valuation methodology is a theme whose time has come. With the PEIGG guidelines now taking hold in the US and the EVCA, AFIC and BVCA guidelines becoming the gold standard in Europe, it is imperative to explain how a valuation at other than cost is determined. And, holding companies at cost for a long time after the investments have been made probably is not a good idea. This approach may not provide an accurate or timely picture of a company's performance. A PPM that lacks a reference to the methodology utilised to determine the valuation of the unrealised portfolio means (oops, dare I say it?) more work for the reader.

I think this about sums up most of the main things that drive investors to reach for their guns. No doubt there are more and we haven't even touched on pet peeves like having no page numbers, having too many graphs and charts, having too few graphs and charts – the list could be endless. Following these guidelines does not guarantee an investment. It doesn't even guarantee a serious evaluation. But it's difficult to imagine a favourable response leading to a more detailed review by an investor if your PPM does not reflect the informed and well organised presentation investors need to get them to the next step in their process. ■

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