# Private fund managers, deals and exits

Private Markets

## 1 A story: hiring a farm manager

- Investors hand over money for ten years or more
- They cannot easily leave or watch every day
- LPs invest; the GP finds, buys, improves, sells
- Noor must decide whether Marlowe Ridge deserves trust

IN THE LESSON

- Picture a family that owns land but has no time to farm it.
- They hire a manager for ten years.
- The family cannot easily sack the manager, cannot sell the land early, and cannot watch every day.
- So what do they need?
- A manager who finds good land, runs it well, tells the truth about its value, and is paid mostly when the family does well.
- A private fund is built the same way.
- The investors are called limited partners, or L Ps.
- The manager is the general partner, or G P.
- Noor Okafor works for one limited partner, Tern Pension Trust.
- She must decide whether Marlowe Ridge deserves its trust.

## 2 What the general partner does

*Before the deal closes*

Raise the fund → Source and screen deals → Diligence, price, finance

*After the deal closes*

Oversee the company →
Call cash, value, report →
Plan and run the exit

IN THE LESSON

- Here is the general partner's job as a flow.
- The top row is everything before a deal closes.
- The manager raises the fund from investors, then sources and screens possible deals, then carries out due diligence and structures, prices and finances the purchase.
- The bottom row is everything after.
- The manager oversees each company through board seats, hands on operating help, and shares for the management team, which we call management incentives.
- It calls cash from investors when needed, hands cash back, values the holdings and reports to the limited partners, often to an advisory committee made up of some of them.
- Finally it plans and carries out the sale, which is when investors are finally paid.

## 3 What the GP owes its investors

*Four things Noor looks for in the agreement*

| What the GP owes | Called |
|---|---|
| Act in investors' interest first | Fiduciary |
| Put its own money in the fund | Commitment |
| Carry unlimited liability | Liability |
| Report and value fairly | Reporting |

IN THE LESSON

- The general partner owes its investors more than a good result.
- First, a fiduciary duty, which means acting in their interest, with loyalty and care, ahead of its own.
- Second, it normally puts some of its own money into the fund, so it loses when they lose.
- Third, it carries unlimited liability, usually through a separate company set up for the purpose, called a special purpose entity.
- Fourth, it must report honestly, value holdings fairly, and answer to the L P advisory committee, a small group of investors that checks on conflicts.
- Noor treats these four as a checklist.
- Each one should be written into the fund's agreement, not merely promised over lunch.

## 4 The trap: overlooking conflicts

- Deals shared out between the manager's funds
- Transaction and monitoring fees charged to companies
- Trades between its own funds at a price it sets
- Generous values just before a new fundraise

IN THE LESSON

- Now the trap.
- A manager that owes duties still has conflicts, and Noor must look for them.
- One: deals are shared between its funds, so an older fund may get the better ones.
- Two: it charges transaction and monitoring fees to the companies, which the investors own.
- Three: it trades holdings between its own funds at a price it sets itself.
- Four: it gives holdings generous values just before it raises its next fund, because high values make the track record look better.
- None of these is wrong by itself.
- The question is whether the agreement manages them, with clear rules, disclosure and the advisory committee.
- A good manager shows you the rules before you ask.

## 5 Example 1: fees paid by the companies

*Fund III: 120 committed, 2% fee. All figures in millions*

| | | |
|---|---|---|
| **Fee before offset** | 2% × 120 | **2.4** |
| **Fees paid by the companies** | 0.5 + 0.3 | **0.8** |
| **Offset at 75%** | 0.75 × 0.8 | **0.6** |
| **Fee after offset** | 2.4 − 0.6 | **1.8** |
| **Kept by GP, outside offset** | 0.8 − 0.6 | **0.2** |

IN THE LESSON

- Here is the second conflict in numbers.
- Fund III has one hundred and twenty million of commitments and charges a management fee of two per cent, which is two point four million a year.
- This year the portfolio companies paid the manager transaction fees of zero point five and monitoring fees of zero point three, together zero point eight million.
- The agreement offsets seventy five per cent of those fees against the management fee.
- Seventy five per cent of zero point eight is zero point six.
- So the fee falls from two point four to one point eight.
- The manager still keeps zero point two million of fees paid by companies that the investors own.
- Noor should ask for a full offset in the next fund.

## 6 A story: paying the builder

- Own money in the fund; carry (often 20%) only on profit
- Hurdle: investors get a minimum return first
- Catch-up, then a split of what is left
- Clawback, fee offsets, key-person clauses

**IN THE LESSON**

- Suppose you hire a builder.
- Pay a fixed fee and the builder has no reason to care how the house turns out.
- Pay nothing unless it sells at a profit and the builder may take wild risks.
- The best contract sits in between: a modest fee to keep the lights on, and a big share of the profit, but only after you have profited.
- Private funds work this way.
- The tools are the manager's own money in the fund, carried interest, which is a share of profit usually set at twenty per cent, a hurdle, which is a minimum return investors receive first, a catch-up, and clawback, which makes the manager return carry it was paid too early.
- Fee offsets and key person clauses add protection.

## 7 The three kinds of pay

*What each kind of pay is charged on*

| Pay to the manager | Charged on |
|---|---|
| Fee, investment period | Committed |
| Fee, later years | Invested/NAV |
| Carried interest | Profit |

**IN THE LESSON**

- Let us separate the manager's pay into its parts.
- The management fee is the manager's salary.
- During the investment period, in the early years, it is charged on committed capital, meaning every pound the investors promised, whether or not it has been spent yet.
- Afterwards it is normally charged on invested capital, or on net asset value, which falls as companies are sold.
- Carried interest is the bonus.
- It is charged only on profit.
- Notice how the fee base moves.
- The investors pay for the manager's time even on money that is not yet working, which is why Noor looks at the whole bill and not just the headline rate.

## 8 Example 2: Fund III's total fees

*Fund III: 120 committed, all paid in; 100 invested; 2% fee*

| | | |
|---|---|---|
| **Years 1 to 5 fee** | 2% × 120 committed | **2.4 a year** |
| **Five years of it** | 2.4 × 5 | **12.0** |
| **Years 6 to 10 fee** | 2% × 80 invested | **1.6 a year** |
| **Five years of it** | 1.6 × 5 | **8.0** |
| **Total fees** | 12 + 8 | **20.0** |

**IN THE LESSON**

- Let us build Fund III's fees.
- Commitments are one hundred and twenty million, and the fee is two per cent.
- In the five year investment period the fee is on commitments, so it is two point four a year, twelve in all.
- Then the base switches to invested capital.
- Some companies have been sold, so eighty is still invested.
- Two per cent of eighty is one point six a year, which is eight over five years.
- The total is twenty.
- So the investors paid in one hundred and twenty: one hundred went into companies and twenty went on fees.
- That gap between what is paid in and what is invested is the first thing between the gross result and the net.

## 9 Carry and the net multiple

**Carry = rate × profit**
**Net multiple = (returned − carry) ÷ paid-in**

| | |
|---|---|
| **Paid-in capital** | Invested plus fees |
| **Profit** | Returned less paid-in |
| **Carried interest** | Rate times profit |
| **Net multiple** | What LPs keep per unit paid |

IN THE LESSON

- Now the two formulas that turn gross into net.
- Paid in capital is everything the investors have sent in, fees included.
- Profit is what the fund returns, minus that paid in capital.
- Carried interest is the carry rate times the profit, so the manager shares only in gains, and only after investors have their money back.
- The net multiple is what the limited partners actually receive, which is the cash returned less the carry, divided by what they paid in.
- Compare that with the gross multiple, which looks only at the companies and ignores fees and carry.
- Noor always quotes the net multiple, because it is the one her pension trust keeps.

## 10 Example 3: the simplest case

*100 paid in; fund returns 160; carry 20%, no hurdle*

| | | |
|---|---|---|
| **Profit** | 160 − 100 | **60** |
| **Carry** | 20% × 60 | **12** |
| **LPs receive** | 160 − 12 | **148** |
| **Gross multiple** | 160 ÷ 100 | **1.60×** |
| **Net multiple** | 148 ÷ 100 | **1.48×** |

IN THE LESSON

- Here is the simplest case, with no hurdle.
- The investors pay in one hundred, and the fund returns one hundred and sixty.
- The profit is sixty.
- Carry at twenty per cent of sixty is twelve.
- So the limited partners receive one hundred and sixty less twelve, which is one hundred and forty eight.
- The gross multiple is one hundred and sixty over one hundred, one point six zero times.
- The net multiple is one hundred and forty eight over one hundred, one point four eight times.
- Notice the size of the gap.
- The manager's carry took twelve out of a sixty profit.
- That is what a carry rate of twenty per cent promises, and the investors keep the rest.

## 11 The catch-up

**Catch-up = hurdle amount × c ÷ (1 − c)**

| | |
|---|---|
| **Hurdle amount** | Paid to the LPs first |
| **Carry rate** | c, e.g. 20% of profit |
| **Catch-up** | Paid 100% to the GP |

IN THE LESSON

- Real funds add a hurdle and a catch-up.
- The hurdle, or preferred return, is a minimum return the investors receive before the manager shares in anything.
- It builds up each year, compounding.
- The catch-up then lets the manager take all of the next cash until it has twenty per cent of the profit paid so far.
- How much is that?
- If the carry rate is c, the catch-up equals the hurdle amount times c, divided by one minus c.
- With a full catch-up the hurdle delays the carry, but does not reduce it, as long as the fund clears the hurdle by enough.

## 12 Example 4: the whole-fund waterfall

*Paid in 120; returned 240; hurdle accrued 30; 80/20 split*

| | | |
|---|---|---|
| **Capital back to LPs** | 120 of 240 | **120** |
| **Hurdle to LPs** | leaves 90 | **30** |
| **Catch-up to GP** | 30 × 0.2 ÷ 0.8 | **7.5** |
| **Split of 82.5** | LPs 66, GP 16.5 | **80/20** |
| **Totals: LPs 216, GP 24** | 24 = 20% × 120 | **216** |

IN THE LESSON

- Now the full waterfall for Fund III, paid in the order a whole fund, or European, structure uses.
- The limited partners paid in one hundred and twenty, and the fund returns two hundred and forty.
- Step one, capital back: one hundred and twenty goes to the investors, which leaves one hundred and twenty of profit.
- Step two, the hurdle: thirty accrued, so thirty goes to them, leaving ninety.
- Step three, the catch-up: thirty times point two over point eight is seven point five to the manager.
- That leaves eighty two point five.
- Step four, split eighty twenty: the investors get sixty six and the manager sixteen point five.
- Totals: investors two hundred and sixteen, manager twenty four, which is twenty per cent of the one hundred and twenty profit.

## 13 Where the gross profit went

*Profit (millions)*

| | |
|---|---|
| **Gross profit** | **140** |
| **Fees** | **−20** |
| **Carry** | **−24** |
| **LP profit** | **96** |

*Gross 2.40× = 240 ÷ 100; net 1.80× = 216 ÷ 120*

IN THE LESSON

- Here is that result as a picture.
- The vertical axis is profit, in millions.
- The first bar is the gross profit on the companies: two hundred and forty returned, less the one hundred invested, which is one hundred and forty.
- The second bar is the twenty of fees we built earlier.
- The third bar is the twenty four of carry.
- What is left is the fourth bar, ninety six, the profit the limited partners keep.
- So the gross multiple is two point four zero times, two hundred and forty over one hundred invested.
- But the net multiple is one point eight zero times, two hundred and sixteen over one hundred and twenty paid in.
- A headline of more than double has become one point eight.
- That is the cost of fees and carry.

## 14 Example 5: deal by deal and clawback

*Three deals cost 100 each; sold for 200, 100, 40 (a loss of 60)*

| | | |
|---|---|---|
| **Carry paid after deal one** | 20% × (200 − 100) | **20** |
| **Fund profit after all deals** | 340 − 300 | **40** |
| **Carry owed on whole fund** | 20% × 40 | **8** |
| **Overpaid; clawback due** | 20 − 8 | **12** |
| **LP net multiple, with clawback** | 332 ÷ 300 | **1.11×** |

**IN THE LESSON**

- The trap is the order of payment.
- In a deal by deal, or American, waterfall the manager is paid carry as each deal is sold.
- Take three deals that cost one hundred each.
- They are sold for two hundred, then one hundred, then forty.
- After the first sale the manager takes twenty per cent of the hundred profit, twenty.
- Then the third deal loses sixty.
- Across the fund the profit is only forty, so carry owed is eight.
- The manager has been overpaid by twelve.
- A clawback provision makes it hand back the twelve, if it can be enforced.
- With it, the limited partners end with three hundred and thirty two on three hundred paid in, a net multiple of one point one one times.
- Without it, they would end with a lower figure.

## 15 A story: two kinds of buyer

- Buyout: steady cash flow that can carry debt
- Defensible position, low capex, assets as collateral
- Venture: big market, scalable product, strong team
- Marlowe Ridge studies Brindle Packaging

**IN THE LESSON**

- Two people shop for investments.
- The first wants a block of flats with long term tenants, steady rent and few repairs, because the rent will cover the mortgage.
- The second wants a tiny company with a clever invention, knowing most will fail but one may be worth a fortune.
- The first is a buyout investor, and the second is a venture investor.
- Good buyout targets have predictable cash flows that can service debt, a defensible market position, modest capital spending, assets that can serve as collateral, and room to improve under better owners.
- A good venture target has a large addressable market, a scalable product and a strong founding team.
- Marlowe Ridge is a buyout house, so it studies Brindle Packaging.

## 16 What each kind of investor wants

*Qualities that make a target appealing*

| Quality investors look for | Fits |
|---|---|
| Predictable cash flow to carry debt | Buyout |
| Modest capex; assets as collateral | Buyout |
| Room to improve under new owners | Buyout |
| Large market, scalable, strong team | Venture |

**IN THE LESSON**

- Here is the checklist.
- Noor and Marlowe Ridge ask the same question of every candidate: what makes this one appealing?
- For a buyout, the answers are predictable cash flows, modest capital spending, assets that can back a loan, and room to improve.
- A buyer cannot improve what it cannot control, so concentrated ownership matters too, because it lets the owner replace weak management and set clear targets.
- For venture capital the picture is different.
- Cash flows are negative today, so debt is out of the question.
- What matters is the size of the market, a product that can scale, and the people building it.
- Brindle Packaging fits the buyout column well.

## 17 Example 6: can the target carry the debt?

*Debt 120 (4.0× EBITDA of 30) at 7% interest*

| | | |
|---|---|---|
| **Interest per year** | 7% × 120 | **8.4** |
| **Normal year cover** | 30 ÷ 8.4 | **3.57×** |
| **Stable target, EBITDA −10%** | 27 ÷ 8.4 | **3.21×** |
| **Volatile target, EBITDA −50%** | 15 ÷ 8.4 | **1.79×** |

IN THE LESSON

- Why does predictability matter so much?
- Because of debt.
- Marlowe Ridge plans to borrow one hundred and twenty to buy Brindle, which is four times its EBITDA of thirty.
- At seven per cent, the interest is eight point four a year.
- In a normal year, EBITDA covers the interest three point five seven times.
- Now a bad year.
- If Brindle is stable and EBITDA falls ten per cent to twenty seven, cover is three point two one times, still comfortable.
- If a volatile target with the same debt saw EBITDA halve to fifteen, cover would drop to one point seven nine times, dangerously thin.
- Same debt, very different safety.
- That is why steady cash flow is the first test.

## 18 Where the equity gain comes from

**Gain = growth + multiple change + debt paydown**
**Growth = (EBITDA out − in) × multiple in**
**Multiple change = (multiple out − in) × EBITDA out**

| | |
|---|---|
| **Growth** | Operations the GP controls |
| **Multiple change** | Market conditions, not skill |
| **Debt paydown** | Debt in less debt out |
| **Equity gain** | Exit equity less equity in |

IN THE LESSON

- Where do private owners add value?
- Three places on the operating side.
- Better operations: revenue growth and wider margins, which raise EBITDA.
- Better governance, because concentrated ownership and management shares reduce the gap between owners and managers.
- And buy and build, where the owner adds smaller companies to the platform.
- On the financial side there are two more: paying down debt, and a higher exit multiple.
- We can split the equity gain into those pieces.
- Growth is the rise in EBITDA times the entry multiple.
- Multiple change is the change in multiple times the exit EBITDA.
- Debt paydown is debt in less debt out.
- The three add up to the gain, and nothing is left over.

## 19 Example 7: Plan A, built on operations

*Buy at 8× EBITDA 30; debt 120; year 5: EBITDA 42, debt 60*

| | | |
|---|---|---|
| **Equity in** | 8 × 30 − 120 | **120** |
| **Equity out, year 5** | 8 × 42 − 60 | **276** |
| **EBITDA growth** | (42 − 30) × 8 | **96** |
| **Debt paydown** | 120 − 60 | **60** |
| **Multiple change** | (8 − 8) × 42 | **0** |

IN THE LESSON

- Marlowe Ridge's first plan for Brindle is built on operations.
- It buys at eight times EBITDA of thirty, and borrows one hundred and twenty, so the equity in is eight times thirty, less one hundred and twenty, which is one hundred and twenty.
- After five years EBITDA is forty two, debt has been paid down to sixty, and the exit multiple is still eight.
- Equity out is eight times forty two, less sixty, which is two hundred and seventy six, so the gain is one hundred and fifty six.
- Of that, growth is twelve times eight, ninety six.
- Debt paydown is sixty.
- Multiple change is nothing.
- The whole gain comes from things the manager controls, and none of the gain relies on the market.

## 20 Example 8: Plan B, built on the market

*Same entry; year 5: EBITDA 33, multiple 9×, debt 90*

| | | |
|---|---|---|
| **Equity out, year 5** | 9 × 33 − 90 | **207** |
| **EBITDA growth** | (33 − 30) × 8 | **24** |
| **Debt paydown** | 120 − 90 | **30** |
| **Multiple change** | (9 − 8) × 33 | **33** |
| **Share from the multiple** | 33 ÷ 87 | **38%** |

**IN THE LESSON**

- A rival plan for Brindle looks different.
- EBITDA grows only to thirty three, debt is paid down only to ninety, but the exit multiple is assumed to rise from eight to nine.
- Equity out is nine times thirty three, less debt of ninety, which is two hundred and seven.
- The gain is eighty seven.
- Growth is three times eight, twenty four.
- Debt paydown is thirty.
- Multiple change is one times thirty three, thirty three.
- So thirty three of the eighty seven, about thirty eight per cent, depends on a higher exit multiple, which depends on the market and not on skill.
- Noor would trust Plan A and ask what happens to Plan B if the multiple never rises.

## 21 Two plans, three sources of gain

*Equity gain (millions)*

| | |
|---|---|
| **A: growth** | **96** |
| **A: debt** | **60** |
| **A: multiple** | **0** |
| **B: growth** | **24** |
| **B: debt** | **30** |
| **B: multiple** | **33** |

*Plan A gain 156; Plan B gain 87*

**IN THE LESSON**

- Here are both plans as bars.
- The vertical axis is the equity gain in millions, and each bar is one source.
- The first three bars are Plan A.
- Growth is ninety six and debt paydown is sixty, both tall, and the multiple bar is nothing.
- The next three bars are Plan B.
- Growth is twenty four, debt paydown is thirty, and the multiple bar of thirty three is the tallest of the three.
- The first plan gains one hundred and fifty six, and almost all of it is operational.
- The second gains only eighty seven, and a large slice relies on the market.
- When you present an investment case, lead with the levers the manager controls.
- Treat multiple expansion and cheap leverage as luck, not skill.

## 22 Mistakes to avoid so far

- Overlooking the manager's conflicts of interest
- Quoting gross multiples as what LPs keep
- Deal-by-deal carry with no enforceable clawback
- Plans resting on multiple expansion or cheap debt
- Ignoring whether volatile earnings can service debt

**IN THE LESSON**

- Let us collect the common mistakes from the first three topics.
- One: overlooking the manager's conflicts, such as fees charged to companies or generous values before a fundraise.
- Two: quoting the gross multiple as if it were what investors keep, when fees and carry sit in between.
- Three: accepting a deal by deal waterfall with no clawback that can actually be enforced.
- Four: backing a plan that rests on multiple expansion or cheap borrowing, which reflects the market and not the manager.
- Five: forgetting that debt must be serviced, so a target with volatile earnings can be dangerous even when its average profit looks fine.

## 23 A story: the mechanic's inspection

- Due diligence tests the investment thesis
- Findings change price, structure, protections
- Or they lead the buyer to walk away
- Trap: diligence that only confirms a decided deal

IN THE LESSON

- A friend offers to sell you a used car and swears it has never had a problem.
- You would still pay a mechanic to look at it.
- Due diligence is that inspection.
- It is not a formality.
- It tests the investment thesis, the story of why this company is worth buying.
- The findings have to change something: the price, the debt and how the deal is structured, the protections in the contract, or the decision itself, because sometimes the right answer is to walk away.
- The trap is to treat diligence as confirmation of a deal that has already been decided, and so to explain away every bad finding.

## 24 What diligence covers and what it changes

*Investigate: market, earnings, law, tax, operations, people*

Commercial work → Financial work → Legal, tax, ESG, people

*Findings change*

The price → Debt and protections → Or walk away

IN THE LESSON

- Here is the flow.
- The top row lists the investigation.
- Commercial work looks at the market and the competitors.
- Financial work tests the quality of earnings, the working capital and the existing debt.
- Legal, tax, operational, environmental, social and governance, and management reviews complete the picture.
- The bottom row shows where the findings go.
- They flow into the price, because a problem lowers what the buyer should pay.
- They flow into the capital structure and the deal protections, such as warranties from the seller, an earn-out, which holds back part of the price until targets are met, or an escrow, where money is held aside.
- And if a problem cannot be fixed or priced, the buyer should walk away.

## 25 Example 9: quality of earnings

*Seller asks 8× reported EBITDA of 34; one-offs 4*

| | | |
|---|---|---|
| **Seller's ask** | 8 × 34 | **272** |
| **Adjusted EBITDA** | 34 − 4 | **30** |
| **Price on adjusted EBITDA** | 8 × 30 | **240** |
| **Value removed by diligence** | 272 − 240 | **32** |
| **Debt lenders will give** | 4.0 × 30 | **120** |

IN THE LESSON

- Here is financial diligence at work on Brindle.
- The seller markets Brindle at eight times EBITDA of thirty four, an ask of two hundred and seventy two.
- The accountants dig into the thirty four and find add backs of four, described as one off, which are costs that keep happening.
- Removing them leaves adjusted EBITDA of thirty.
- Eight times thirty is two hundred and forty.
- So diligence has taken thirty two of value out of the price.
- The lenders look at the adjusted figure as well, so at four times thirty they will lend one hundred and twenty, not more.
- Marlowe Ridge might bridge the gap with an earn-out, paid only if the seller's claimed earnings really appear.
- That is how findings flow into price and structure.

## 26 The business plan makes it measurable

*Brindle plan from entry to year 5; exit in year 5*

| Target | Entry to year 5 |
|---|---|
| Revenue | 200 to 240 |
| EBITDA margin | 15% to 17.5% |
| EBITDA | 30 to 42 |
| Debt ÷ EBITDA | 4.0× to 1.4× |

IN THE LESSON

- Diligence feeds the business plan, often called a value creation plan.
- It turns the thesis into measurable targets that management can be held to.
- Here is Brindle's plan over five years.
- Revenue grows from two hundred to two hundred and forty.
- The EBITDA margin widens from fifteen to seventeen and a half per cent, which lifts EBITDA from thirty to forty two.
- Debt falls from four times EBITDA to one point four times.
- The sale is planned for year five.
- These targets anchor the valuation, they set the financing, and they give the board a scorecard to monitor every quarter.
- A plan without milestones management can be held to is only a hope.

## 27 A story: selling the renovated house

- A holding becomes a return only when it is sold
- Routes differ in price, certainty and speed
- Share sold matters; test the effect on IRR
- Brindle, year 5: equity cost 120

IN THE LESSON

- Think of a house you bought, renovated and now want to sell.
- You could sell to a neighbour who loves it, to a developer who sees extra value, or to an investor who wants it quickly.
- Same house, but a different price, a different wait and a different risk.
- A private holding is the same.
- It only turns into a return when it is sold, and the route you choose changes the price, the certainty, the speed and the share you sell.
- Marlowe Ridge now owns Brindle in year five, with equity that cost one hundred and twenty.
- Which route should it take, and what does each do to the return?

## 28 The ways out

*Full exits*

Trade sale → Secondary buyout → IPO and sell-down

*Partial liquidity or failure*

Dividend recap → Write-off → Liquidation

IN THE LESSON

- Here are the ways out.
- The top row holds the full exits.
- A trade sale goes to a strategic buyer, a company in the same business, and it usually gives a full cash exit, often at a premium that reflects the savings the buyer expects.
- A secondary buyout sells to another sponsor.
- It is quick and certain, though the buyer may see less room to improve.
- An initial public offering, or I P O, can reach a high valuation, but it is costly and depends on the market, and lock ups mean the sponsor sells down in stages.
- The bottom row holds the rest.
- A dividend recapitalisation returns cash but is only partial liquidity.
- A write off or liquidation is the failure case.

## 29 From multiple to IRR

**IRR = multiple^(1 ÷ years) − 1**

| | |
|---|---|
| **Cash multiple** | Cash back over cash in |
| **Years held** | Time between the two |
| **IRR** | Yearly return |

IN THE LESSON

- To compare routes we need one more tool.
- The cash multiple says how many times the money came back.
- The internal rate of return, or I R R, says how fast.
- With one amount invested and one received, the I R R is the multiple raised to the power of one over the years held, minus one.
- A larger multiple raises it.
- A longer wait lowers it, because the same gain is spread over more years.
- This is why speed matters.
- Two exits with the same multiple can have very different returns if one pays sooner.
- When cash arrives in several pieces, as with an I P O sell down, the same idea applies, but the calculation needs a calculator.

## 30 Example 10: Brindle's three routes

*Year 5: EBITDA 42, debt 60; equity in 120; IPO costs 5%*

| | | |
|---|---|---|
| **Trade sale at 9×** | 378 − 60 = 318 | **2.65×, 21.5%** |
| **Secondary buyout at 8×** | 336 − 60 = 276 | **2.30×, 18.1%** |
| **IPO 8.5×: 40% now, 60% in a year** | 112.9 + 169.3 | **2.35×, 16.6%** |
| **IPO, market −15% before the 60%** | 112.9 + 143.9 | **2.14×, 14.7%** |

IN THE LESSON

- Now compare the routes for Brindle in year five.
- EBITDA is forty two, debt is sixty, and the equity cost one hundred and twenty.
- A strategic buyer pays nine times for the synergies.
- Value is three hundred and seventy eight, equity three hundred and eighteen, a multiple of two point six five times and an I R R of twenty one point five per cent.
- A secondary buyer pays eight times, equity two hundred and seventy six, two point three zero times, eighteen point one per cent.
- An I P O at eight and a half times sells forty per cent at listing and the rest a year later, with five per cent costs.
- The cash arrives as one hundred and twelve point nine, then one hundred and sixty nine point three.
- That gives two point three five times but only sixteen point six per cent.
- If the market falls fifteen per cent first, it is two point one four times and fourteen point seven.
- Speed and certainty both have a price.

## 31 Same multiple, longer wait

*Chart: IRR (%) vs Years held (3 to 8)*

- 2.65× at 5 years: 21.5%
- 2.30× at 5 years: 18.1%
- 2.30× at 8 years: 11.0%
- Year 5

**IN THE LESSON**

- This picture shows why speed matters.
- The horizontal axis is years held.
- The vertical axis is the yearly return, the I R R.
- The green curve is a cash multiple of two point six five times, like the trade sale.
- The orange curve is two point three zero times, like the secondary buyout.
- Both fall as the years pass, because the same gain is spread over more time.
- At five years the green curve gives twenty one point five per cent and the orange gives eighteen point one per cent.
- If the orange holding were held eight years instead, it would give only eleven per cent, the lowest point on the picture.
- The longer money waits, the less each year earns.

## 32 Example 11: the dividend recap trap

*Year 3: EBITDA 36, debt 90; re-lever to 5.0×; debt 160 at sale, year 5*

| | | |
|---|---|---|
| **Dividend = new debt − old debt** | 180 − 90 | **90** |
| **Year 5 equity** | 336 − 160 | **176** |
| **Multiple, against holding** | (90 + 176) ÷ 120 | **2.22× vs 2.30×** |
| **IRR, against holding** | year 3 and year 5 cash | **20.7% vs 18.1%** |
| **Interest cover, year 3** | 36÷6.3 to 36÷12.6 | **5.7× to 2.9×** |

**IN THE LESSON**

- Last, the dividend recapitalisation.
- In year three, Brindle's EBITDA is thirty six and debt is ninety.
- Marlowe Ridge re-levers to five times EBITDA, which is one hundred and eighty of debt, and pays the difference of ninety to itself as a dividend.
- It keeps all the shares.
- At the year five sale, the extra debt means less has been repaid, so debt is one hundred and sixty and equity is one hundred and seventy six.
- Total cash is ninety plus one hundred and seventy six over one hundred and twenty, two point two two times, below the two point three zero times from simply holding.
- But the I R R rises to twenty point seven per cent from eighteen point one.
- Interest cover falls from five point seven times to two point nine.
- Higher return, higher risk of default.

## 33 Recap: the lesson in five lines

- GP: duties owed, conflicts watched
- Carry, hurdle, clawback; judge the net multiple
- Steady cash and operational levers beat luck
- Diligence moves price and terms; plans have milestones
- Pick exits by price, certainty, speed, share sold

**IN THE LESSON**

- Let us pull the lesson together.
- First, the general partner raises, buys, runs and sells, and owes its investors a fiduciary duty, its own capital and honest reporting, but conflicts need watching.
- Second, carry, hurdles, catch-ups and clawbacks tie the manager to the investors, and the net multiple is what the investors keep after fees and carry.
- Third, good targets have steady cash flow and room to improve, and a case built on operations beats one built on the market.
- Fourth, diligence must change the price, the structure or the decision, and the plan must be measurable.
- Fifth, choose the exit by price, certainty, speed and share sold, and test it against the yearly return.

## 34 Try three quick questions

1. 100 paid in, 150 returned, 20% carry, no hurdle. Net multiple?
   **Answer:** Profit 50, carry 10, LPs get 140: 1.40×.
2. Seller asks 10× EBITDA of 20; diligence removes 2 of one-offs. Price?
   **Answer:** Adjusted EBITDA 18, so 10 × 18 = 180.
3. Equity bought for 100 sells for 200 after 4 years. IRR?
   **Answer:** 2^(1÷4) − 1 = 18.9% a year.

**IN THE LESSON**

- Now try three quick questions yourself.
- Pause after each one.
- Question one.
- A fund is paid in one hundred, returns one hundred and fifty, and charges twenty per cent carry with no hurdle.
- What is the net multiple?
- The profit is fifty, carry is ten, investors receive one hundred and forty, so the net multiple is one point four zero times.
- Question two.
- A seller asks ten times EBITDA of twenty, and diligence removes two of one off items.
- What is the new price?
- Adjusted EBITDA is eighteen, so ten times eighteen is one hundred and eighty.
- Question three.
- Equity bought for one hundred is sold for two hundred after four years.
- What is the I R R?
- Two to the power of one quarter, less one, is eighteen point nine per cent.
- Check your answers against the board.