

What makes a good private equity investment?

Private Equity › Interview Preparation



Investment Banking, Private Equity
& Venture Capital Articles, Guides & Jobs

This is a very common Private Equity interview question, and you might also encounter that type of question in interviews for investment banking, equity research or even capital markets roles. Not all companies are suitable targets for LBOs, and private equity firms will only invest in companies exhibiting the following characteristics:

Strong and stable cash flows

Private equity deals get enhanced returns because they use a significant portion of debt to finance their investments. For example, if the company costs £100, they can typically use £50 of their own cash to pay for it, and £50 of debt. The process of using debt is called "leveraging" or "gearing" a company. This means that the company will have to make substantial monthly or quarterly interest and principal repayments on the debt, and it cannot afford to miss any of those payments. For this reason, the bankers will only be happy to lend significant amounts of money to companies that have strong, stable, and predictable cash flow.

Low capital expenditure requirements

Private equity tends to stay away from companies that require heavy investments in plants, machinery, or equipment as these are a drain on cash. Examples of capital expenditure intensive industries are energy, utilities, manufacturing, construction, and transportation. Industries that require less capital expenditure are software companies, online businesses, and publishing ventures.

Leading market positions

Attractive companies have proven products and good management, which usually translates into a "top three" positioning. Strong positioning is also typically synonymous with strong and more stable cash flow.

High barriers to entry, niche markets

High barriers to entry and niche positioning will protect the company from competition, which could hurt cash flow and the company's ability to repay debt.

Potential for margin improvement or cost reduction

This can be observed by comparing the company cost structure to its competitors and will be a source of value creation for private equity, which will "restructure" the business to some degree. Private equity firms often hire consultants that identify those strategic and cost improvements.

Strong existing management team or availability of new management team

Strong management is always a positive, even though new management is often brought in during a LBO.

Acquisition opportunities

Acquisitions are a good way to grow companies quickly. Therefore, private equity firms will analyse the industry to identify potential targets. An industry with many players is called "fragmented".

Good exit potential

A private equity firm will need to be convinced that a suitable exit can be found. This will normally occur by way of trade sale (selling to another company), secondary sale (selling to another private equity firm) or IPO. A buyer will typically have a time horizon of between three and five years, although a number of financial buyers target longer or shorter periods.

Download More Free Articles & Guides at AskIvy.Net