Winter 2004

Investing for the future

B. P. MARSH & PARTNERS LIMITED

VIEWPOINT: People matter

I'd like to dispel an illusion that seems to have taken hold in today's business environment – that it's all about numbers and technology. As an investor in many different kinds of financial services businesses throughout 40 years, I would say that it's the people rather than just the figures and the hardware and software that make for long term financial success. So although we are naturally interested in financial projections and new electronic techniques, we know that the combination of accountants and computer consultants does not make a business.

What distinguishes these people who can really make a difference when it comes to starting or developing a company? We are looking for honesty obviously and also for diligence. Often they are individuals and teams whose creativity and individualism is not part of the focus of the big global corporations in which they work. Having a niche product is important as well and we are not restrictive in terms of the type of product or service involved. And if someone who is honest and diligent wants to set up their own business or to raise some money and has a very focused approach to some aspect of the market, injecting some equity capital for growth need not be a very complicated deal.

And what distinguishes us? We take minority stakes in small to medium sized operations. Obviously what we bring to the table is money. That is the oil on which everything runs and it is often in short supply. But in addition to that we bring an enormous bank of experience of how to manage and run new and small businesses. In a start-up situation, typically, we will be approached by an individual or team that has a special scheme which has great potential for development but the people concerned will not know anything about the regulatory requirements for running a company such as what is involved in being a company secretary. So we offer our small and medium sized investments a complete range of corporate services.

One final illusion that I'd like to dispel is that it's not so easy nowadays to build up a large and successful organisation as it used to be. 'The big boys have got it sewn up' is a common comment. One has only to look at some recent success stories – Google and Ebay for example – to see that there are opportunities for creative and hard working people to build major businesses from scratch.

Brian Marsh, Chairman, B.P. Marsh & Partners Limited

NEWS: Fast growth at Hyperion

Hyperion Insurance Group which includes Howden Insurance Brokers continues to grow rapidly. Acquisitions so far this year include:

- **J K Buckenham Limited** - a 51% share interest in this Lloyd's accredited reinsurance broker, which has a reputation for innovative product development and has expanded its reinsurance base into certain specialist financial and warranty areas.
- **Insurance and Risk Solutions Limited**, now re-named Howden Medical Insurance Services Limited (HMIS) and creating a wholesale medical professional indemnity division of Hyperion's broking arm, Howden Insurance Brokers Limited.
- **Holm & Co** - a controlling 56% interest in this leading Swedish insurance intermediary, which has become the group's Swedish broking arm, further consolidating the group's presence across Scandinavia.

In addition, Howden Insurance Brokers began operating in India in May after being granted the required licence.

Hyperion Insurance Group was established in 1994. Its initial capitalisation was relatively small - £100,000 plus a £0.5m seed capital loan. The directors raised 75% of the capital themselves and went to B.P. Marsh & Partners Limited (BPM) for the remainder. Since then, BPM has made additional loans to finance Hyperion's rapid development.

Headquartered in the City of London, Hyperion is an independently owned insurance and underwriting agency, specialising in worldwide liability and crime insurance products and services. Howden Insurance Brokers is the largest specialist Lloyd's broker of its kind in the UK, with a first-rate reputation worldwide as a market leader in its specialist areas.

> ***"Money is only a tool. It will take you wherever you wish, but it will not replace you as the driver."***
> *Ayn Rand – "Atlas Shrugged" 1957*

An interview with Managing Director Liz Taylor

"I'm the sort of person who wants to change the world and that is difficult when you're working within a big organisation that has lots of rules and procedures. It's absolutely right that they should have those in place – but I found it very restricting," says Liz Taylor, Managing Director of Public Risk Management Ltd (PRM). Liz was in a senior position with a large broking firm, leading the public sector practice, when she first considered starting her own business.

"I realised that at this stage in my career I really wanted to be my own boss," she explains. "I had worked for big organisations on and off for nearly 30 years and, of course, there are all sorts of benefits in doing that. But I had a taste of freedom when I was chairman of the UK Association of Insurance and Risk Managers in 1992/93 and had the opportunity to talk to organisations and the media and to make my own decisions! And I enjoyed it." Liz is also a former chief executive of ALARM, the association of risk managers in the public sector.

BPM were happy to back Liz in her ambition to establish an independent company specialising in providing risk management advice to the public sector. "The deal closed around August last year," says Liz. "Since then, BPM have introduced us to some useful contacts to expand the business. And they're not at all intrusive, in fact they're great to work with".

"The company began with just myself and my partner. Subsequently, we recruited three additional people but it's still a small team. However, through our association with another network, we also have access to over 100 consultants with specific public sector and risk management experience and we reckon we can handle anything that's thrown at us!"

Indeed, PRM's work involves a wide range of projects. "It can be anything from providing training to helping a local authority embed risk management throughout its whole organisation and advising on managing and planning continuity of services, to specifics like strategic overviews of long-term waste management. One of our first jobs was investigating the benefits and risks associated with installing an anaerobic digestion system to process organic waste. We have also developed a number of unique diagnostics," states Liz.

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"We try to do things that are not on offer from everyone else – and the public authorities are very supportive of this. Already, we are extremely busy following up requests for work. They like the idea of an independent in the market place, somebody who is not connected with an audit organisation or an insurer."

PRM also runs advanced training courses for risk management practitioners and offers a wide range of relevant downloadable publications on its website (www.publicriskmanagement.co.uk). For the future, Liz sees PRM continuing to operate in the main stream public sector but increasingly becoming involved not only with local authorities but with government departments, the NHS, further education establishments and the like. "But I didn't see our core team ever exceeding say nine consultants. We're offering a niche service and we don't want to grow too big too quickly."

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Does Liz have any advice for would-be entrepreneurs considering going it alone? "There are huge ups and downs. The ups are great. You've got the freedom to make decisions and the opportunity to take whatever direction you want. But with freedom comes responsibility. That means you have to watch things like cash flow which you don't have to worry about in a big organisation. You keep an eye on costs. And you have to be much more multi-tasked – there's no personnel department or IT department to fall back on.

"When you set up on your own you need to be very organised. We drew up a specific action plan of all the things we needed to do. We had a very short time span in which to finalise the deal, set up the business and start up. We prepared a project management chart and stuck to it rigidly. You need to do that because a lot of things are inter-dependent and have to be done in sequence. For example, until you get your VAT number and registered office, you can't print your stationery. Also you need to be very conservative about your income projections – it takes time to establish a new business and grow."

Liz Taylor,
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"Often the difference between a successful man and a failure is not one's better abilities or ideas, but the courage that one has to bet on his ideas, to take a calculated risk – and to act."
Maxwell Maltz

LEGAL: "So what do I need to sign?"

Peter Kempe of Taylor Wessing discusses the commitments involved in private equity transactions

Since the introduction of the word processor, there has been an unedifying increase in the documentation which investors now expect clients to sign. Ironically, the primary cause is the misconception that standard "one size fits all" precedents create cost savings.

There are however certain documents and standard provisions which will inevitably be required. What can a client expect to be asked to sign?

Although venture capital and private equity models differ, in both scenarios clients can expect to be asked to:

- adopt new joint venture articles;
- enter into an investment agreement; and
- sign new service agreements.

ARTICLES

Preferred ordinary or preference shares

An investor will usually require some form of preferred ordinary share or preference share in order to secure its income and capital return. Rights may include a fixed dividend plus a right to share in an ordinary dividend if it exceeds the fixed sum. Rights may also include a preference on liquidation and sale.

Conversion and anti-dilution rights

Investors may want the right to convert preference shares into ordinary shares on a one for one basis. Certain events will act as an automatic trigger.

Drag along

Companies may have many shareholders when an offer is made. An offer is almost certainly to be on the basis that the purchaser acquires 100% of the company. Under English law 90% acceptance allows the balance to be acquired compulsorily.

A separate "drag along" mechanism is usually sought in the articles to force minority shareholders to sell.

Tag along

Managers conducting day to day management are likely to be first to receive offers for their shares although investors may also wish to participate. "Tag along" provisions ensure that manager shareholders cannot sell unless the purchaser agrees to buy the investors' shares on the same terms.

INVESTMENT AGREEMENT

Subscription

The subscription clause deals with the number of shares which the investor will acquire. The company will issue further shares (ordinary, preference or preferred) to the investor or procure that shareholders sell existing shares.

Warranties

Investors will seek warranties from the company. Key managers and shareholders will also be asked to give warranties about the company's corporate structure, its products, tangible and intangible assets and other key issues. Should those warranties be untrue then damages will flow if the shares acquired are worth less than they would have been had the warranties been true.

Investor protection

Where investors hold minority stakes they will want to ensure the majority shareholder does not take any action which could prejudice its stake. Certain decisions relating to the company and its shares will therefore be prohibited without the investor's prior consent. Minority protection rights are often conditional on investors continuing to hold a minimum overall percentage of the issued shares.

Director or observer

Investors will want to be able to appoint a board director or an observer.

Financial information

That right will be combined with the right to receive financial information including whatever a director would be entitled to see. Monthly management accounts, quarterly or half-yearly reports and information for an annual business plan will also be standard requirements as will the right to examine the books and accounts.

Restrictive covenants

Although key employees will have standard restrictive covenants in their service agreements, investors will want key individuals to enter into separate restrictive covenants to protect the investor's capital investment. These tend to be more onerous than those in a service agreement. Investment agreement covenants are essential to enable an investor to enforce directly (rather than through the company).

Private equity loan documentation

A loan agreement or facility letter accompanied by security documentation will be needed for leveraged private equity deals. The security will include negative covenants.

There will be conditions precedent to an initial draw down and subsequent draw downs.

Service agreements

Key employees need appropriate service agreements combined with appropriate benefit packages including share option arrangements. Key man insurance is also often required together with arrangements to repatriate shares on death.

Overall package

Investment documents are designed to protect the investment being made by a venture capital or private equity firm. They should not be onerous, proscriptive or restrictive. Investors will invest on the strength of their confidence in management. The legal package must not prevent key management from maximising the investment potential of the company in the interests of founder and investor shareholders alike. It should create a framework which protects the investor whilst allowing management to succeed.

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An interview with one of the four founder directors, Andrew Martin

"Most of them have an idea a minute, they're always on your back and they want their equity in three years' time. Your life will be hell." These were the words of warning that Andrew Martin received from a colleague when Andrew said that he was considering using a venture capital firm to finance starting a new business.

Andrew was initially a reluctant entrepreneur. A specialist in the complex world of insurance and reinsurance securitisation involving derivatives, swaps, etc, he was working in one of world's largest brokers "although not really enjoying life". He was approached by a former colleague, Don Paterson, who was keen to start up a niche consultancy in this area. Based in Seattle, Don was working for a highly respected firm of consulting actuaries but felt that there was great scope for going it alone. At first Andrew refused to join him but did say that he would help Don to set up the business – which is where BPM came in.

Andrew knew BPM director Francis de Zulueta from the days when they had both worked for international brokers and risk consultants Marsh & McLennan and went to him for advice. Together with Brian Marsh, founder and Chairman of BPM, they talked the concept through. Through their discussions it became clear that BPM would feel happier investing if Andrew was directly involved in the new venture. "I thought it would be too difficult but I kind of got seduced into it by Brian Marsh and Francis!" says Andrew.

Why didn't Andrew take heed of the initial warning he received about venture capital firms? "BPM's approach is to help bring a start-up to life, and not sandbag it with difficult investor demands while it finds its feet, so that you can do what you are good at," he explains. "And this approach is far more conducive to getting start-ups done than any other venture capital company I've come across. We closed and completed the deal on April 15."

Paterson Martin Limited, as the new firm is called, is a small but international business. "We've got four people in three countries on two continents so we can handle deals virtually anywhere," says Andrew. Current clients – US and Bermudian – include an organisation that is looking to securitise its insurance portfolio which has already gained the backing of a Wall Street bank, and a mutual seeking a securitisation deal to protect its retained surplus from stock market or other volatilities. The firm is currently undergoing the Financial Services Authority approval process to be regulated for both securities and insurance advice.

Having taken the plunge into running their own business, what are Andrew's and Don's plans for the future? "We're hoping to at least double in terms of size and scope in the next few years," explains Andrew. "We are never going to compete with the consulting and investment banking giants. We don't want to be too big. Clients like to talk to the quantitative people – two of my colleagues are actuaries – but the large firms have lapsed back into having client facing, or 'relationship' managers who are often poor translators or articulators of unusual or complex issues. We make sure that the 'quants' are part of the deal team, not a hidden resource.

"We are looking to carve out a niche. We don't want to be just another consulting firm but to get a reputation as people who can arrange innovative products. What we are trying to do is replicate what we have done well in our specialist areas in the past."

BPM is backing the new venture not just with cash but by providing help with some of the intricacies of setting up and running a business. "In my previous roles, I had large corporate legal, accounting, and HR divisions that I could call on to do things for me. We cannot afford that. And I would be the first to admit that we're not brilliant at dealing with formalities like board resolutions. They have really helped us there, and we're also looking forward to exploring synergies in the future."

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