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Private Equity and Entrepreneurship Jargon

Active Investors

In private equity, active investors try to influence the companies in which they invest, in order to increase shareholder value. Active investors join the Boards of their portfolio companies. They offer advice and assistance to management.

Arm's Length

A business transaction negotiated on objective terms by parties who have every reason to get a fair deal for their side. The opposite of self-dealing and nepotism.

Asset Conversion

Changing real and intangible assets into money.

Board

The Board of Directors of a corporation. State laws empower the Board to make or delegate all major decisions for a company. Individuals on the Board may be employees or outside Directors, or some of each. Board members may receive attendance fees and reimbursement for their travel expenses to meetings.

Boiler Plate

Standard clauses in legal documents for a specific kind of contract, such as in a private equity Purchase Agreement. Boiler plate contains some of the longest sentences in the English language. The parties hire lawyers to explain to them what the boiler plate says.

Book

A business plan written by sponsors to raise capital from investors, or to sell the whole company, or to guide management. A good Book must be clear, crisp and easy to read.

Bricks and Mortar

Physical assets of a company, such as factories and office buildings.

Business Enterprise Value (BEV)

The market value of a whole company as an ongoing entity. BEV equals the market value of the company's equity, plus market value of all net debt. Also called, "Value of the Firm."

Buyout

A transaction where investors acquire a whole company from the seller(s). If the buyers use a lot of debt to finance their purchase, it is a Leveraged Buyout. If the buyers include the existing management team of the target company, it is a Management Buyout.

Capital Structure

The amounts of different kinds of financial instrument used to finance any business. Senior debt, junior debt, preferred stock and common stock are the main categories.

Cash Flow

Money coming into, and moving out of, a company through the operation of the business. One always hopes that more money flows in, than out.

Cashout

When an investor sells its ownership stake. Some call this, “Cashing In.” The direction of cash movement may sound confusing, but the selling investor does end up with cash.

Claw Back

The contractual right to make someone return the cash, already taken by that person, back to its original place. A Claw Back occurs when a positive event occurs first (giving someone the right to take cash proceeds), followed by a negative event, as defined.

Closing

A boring event where parties sign thick legal documents and the money changes hands. Buyers and sellers heave a sigh of relief. Lawyers think about a good night’s sleep.

Collateral

Assets of value that a contract party pledges to secure a promise. If one does not keep the promise, then the other party may seize the pledged assets.¹

Comparable Company, Comparable Transaction

Another company, usually with publicly traded securities, that is in the same industry or in a similar business to your company. A Comparable Transaction is an actual deal that is similar to the deal you are trying to do. A Comparable Transaction normally involves a Comparable Company. Analysts use Comparable Companies and any recent Comparable Transactions to help price (value) new deals under consideration.

Control

Owning enough voting stock in a company to have the power to make all the decisions.

Convertible

A type of financial instrument that the holders can exchange for another type of security. Holders often exchange convertible preferred stock and convertible debt for common stock.

Corporate Structure

The legal entity form of a company, whether a corporation, partnership or LLC (Limited Liability Company.) Also refers to the legal ownership structure of subsidiaries and joint ventures, owned by a parent company.

Covenants

Paragraphs in legal documents where the parties make promises about what they will do and what they will not do, during the life of the contract.

¹ Gresham’s Third Rule of Banking: “Never take collateral that eats.”

DCF

Discounted Cash Flow -- a math technique for figuring out today's present value for cash flows that a company will generate over time in the future. DCF works best for large, mature companies. Some professors make a living teaching DCF.

Deal

An agreed bargain between two parties -- such as a buyer and a seller, or a lender and a borrower, or between the counterparties to a long-term, forward foreign currency swap, etc.

Deal Flow

A stream of new investment opportunities found by private equity investors. The number and (especially) the quality of new opportunities can drive one's investment success.

Deal Structure

The key terms and conditions of a private equity investment. Deal structure includes price, the nature and amounts of all the financial instruments (debt, convertible preferred, common stock) and a list of different investors who are investing in such instruments.

Debenture

Another name for a debt, loan or note. A debenture usually is unsecured and long term. The money lender often is an insurance company, a pension fund or the public market. A debenture's legal documentation almost always is impossible to understand.

Debt Service

Obligations to make both principle and interest payments to a lender, on time and in legal currency of the realm. If you make your debt payments on time, you are servicing the debt. If you fail to make timely payments, you are in default (see below).

Default

Failure to make payments of interest or principle on time. More generally, a failure to comply with the promises you have made in a written, legal contract. Contracts normally specify what the consequences are, in event of a default. Consequences can include the loss of your whole company, or loss of all your money, or forfeiture of your collateral.²

Divestiture

A parent company selling an unwanted subsidiary. There are thousands of divestitures each year, many over \$100 million in value. A prime source of deal flow for buyouts.

Documentation

Legal contracts drawn up to bind the parties to their business agreements. Investors usually make any offer to invest, "subject to documentation." This means negotiating satisfactory business terms and conditions, not just hiring lawyers to write up the details in standard legal language. Private equity legal documents can run to hundreds of pages.

² Unless the collateral is a race horse and the other party knows the Third Rule of Banking.

Down & Dirty

Also called, a “Cram Down.” Down & Dirty is a follow-on round of financing done at a low price that substantially dilutes any existing investors who do not participate in the deal.

Downside

The chances of a negative outcome from an investment, such as losing all your money. Investors try to limit their downside risks: (a) by selecting good investments in the first place and (b) by negotiating governance and other deal terms -- that enable them to take action if things do not go well after they have invested.

Due Diligence

Research and analysis of an investment opportunity. The term originally meant a routine investigation by investment bankers of companies that issue public market securities. Several companies, however, managed to defraud the public after only skimpy investigation by bankers. Angry plaintiffs promptly sued the Investment banks for millions (and won). Due Diligence thereafter came to mean thorough, in-depth research and analysis.

Dumb Money

Wealthy investors or financial institutions with reputations for not doing their homework before investing their money. Dumb money investors are a dangerous financing source, since they often become disappointed and angry, and then sue everything that moves.

Early Stage

A new venture company that already has some sales, but needs more financing to ramp up its business to a larger scale. A medium risk category for VC investors.

Earnings Per Share

The net income earnings of common stock, divided by the number of shares of common. See Lecture Note on *Financial Statement Analysis and Ratios* for more details.

Earn Out

A contract between seller and buyer, where the seller will receive extra money if the company's future profits exceed an agreed amount. The parties often place this extra money in escrow until the future arrives.

EBIT

A company's **Earnings Before Interest and Taxes**. EBIT is often the earnings measure of choice for venture capital investors. EBIT is equal to Pretax Profit plus Interest Expense.

EBITDA

A company's **Earnings Before Interest, Taxes, Depreciation and any Amortization**. EBITDA is the earnings measure of choice for buyout investors and sophisticated research analysts. EBITDA is equal to EBIT plus Depreciation Expense, plus Amortization Expense, if any.

Escrow

A bank account, usually controlled by an independent Trustee. Parties place money in an escrow account, pending the final outcome of some event. When the parties know the outcome, the Trustee pays the funds to whomever the contract says should receive them under the circumstances. In practice, the parties often sue each other (and the Trustee) because the exact definition of the relevant event is fuzzy, in someone's opinion.

Equity

A company's full net worth, including preferred and common stock plus retained earnings. The term can mean either the market value or the accounting book value of net worth. Equity also can mean the amount of a person's ownership stake in a company.

Exit

A favorite subject of private equity investors, the Exit means selling all of one's ownership in the business. Venture investors often seem rude to entrepreneurs because they talk constantly about their exit even before they have entered (into an investment deal).

Fair Value

Fair market value of a company's equity, assuming that the company were to be a publicly traded company. Investors often have difficulty agreeing what Fair Value is. They hire independent accountants and investment bankers (for a fat fee) resolve the dispute.

Family Succession Situation

A family-owned company where the surviving family members want to sell out and go sit on the beach. A prime source of deal flow for buyouts. Also called a Legacy Situation.

Financial Ratios

Calculations of the relative size and relationships of income statement and balance sheet items, in financial analysis. See Lecture Note *Financial Statement Analysis and Ratios*.

First Offer

Right to *make an offer* to buy stock from a seller before anyone else does. Similar to a right of first refusal (see below) but more effective from the seller's viewpoint.

First Refusal

Right to *buy stock* from the seller before the seller can dispose of the shares elsewhere. With this variation, the party holding a right of first refusal can wait to see what other buyers are willing to pay. Then top the best offer by \$1. This can discourage the other buyers.

Follow-On

Another round of investment made after the initial one, later in time. Venture capital firms often invest in companies in several phases or stages. Investors make Follow-on investments as a venture company grows and needs additional equity capital.

Fund

A pooled investment vehicle, usually a limited partnership. Pension funds, insurance companies, banks and other wealthy investors -- join together to combine their money under the wise management of private equity professionals. Professional investment managers are the General Partners, and the wealthy investors are the Limited Partners. The Limited Partners put up 99% of the money and receive 80% of the profits, if any. General Partners put up 1% of the money and receive 20% of the profits, if any.

Golden Rule

“He who has the gold, makes the rules.”

Good Management

The key, critical element in most successful private companies. For investors, good managers are people who, among other things, are honest and always keep their promises. The ability to judge the difference between good management and otherwise is the single most important skill of successful private equity investors.

Governance

A series of agreements, usually written into contracts that specify how a company will make key management decisions, and who exactly has the power to make these decisions. Negotiations over governance issues can be as important as price and amount of the deal.

Grace Period

A short period of time (7 to 60 days), during which you may correct some shortcoming, such as a default, without penalty to you. For example, borrowers often have a 10 business day grace period to pay interest after it was due, before the lender can take legal action.

Gremlins

Small mythical creatures -- who quietly can sneak into your deal and cause complications. Most real world deals are full of gremlins, who cause much stress and anxious moments.

Hairball

A complex and unusually tricky investment opportunity.³ Both cats and buyout investors often get hairballs stuck in their throats. Can be fatal.

Haircut

Arbitrary reductions in the optimism of financial projections or in the estimated value of an asset, such as the value of privately held equity or illiquid collateral.

Home Run

Baseball term that refers to a wildly successful investment.

³ See case study, “*PorcoComasas S.A.*” for an example of a large hairball.

Hostile Takeover

An unwanted bid, by a buyer to acquire a company whose management does not want to sell to that buyer. Some private equity investors will not even consider a hostile takeover. Hostile takeover battles can generate bad publicity and messy, costly legal situations.

Insider Information

Information not yet disclosed to the public -- that could have a material effect on the market price of a company's publicly traded securities, if the Company disclosed such information. Investors can use "insider information" to make investments in private companies because there are no publicly traded securities. After an IPO, the VC or buyout investors typically resign from the Board. They then must wait six months or so, to "cleanse" themselves of their prior insider information -- before selling their equity stakes in the market.

IPO

An **I**nitial **P**ublic **O**ffering of new common stock, also called, "Going Public." A typical IPO involves selling from 20%-40% of the total common ownership to the public.

IRR

Internal **R**ate of **R**eturn, usually in excess of 25% per annum, sought by investors in private equity situations. IRR involves compound interest math and desktop computers. It is the economic interest rate received from an investment, consisting of payments (negative values) and income (positive values) over regular time periods. IRR is a favorite topic of private equity investors at power breakfasts and at private clubs.

Junk Bonds

Risky debt instruments created to leverage a buyout. Junk debt usually is subordinate in priority to bank debt and other senior long-term debt. Issuers may sell junk bonds to specialized lenders, or to the public, or in the 1980's -- to Savings and Loan Institutions. Junk debt or bonds carry much higher interest rates than less risky debt in the same deal. When asked at cocktail parties what they do for a living, people in the junk bond business refer to themselves as bankers for "high yield securities."

Knock-on Round

Same as a follow-on financing. (See above.)

Later Stage

A venture company that has sales and has shown good growth, but needs financing to enable it to reach cash flow break-even. Lowest risk category for VC investors.

Lead Investor

Sometimes also called, "the Bell Cow". When a group of private equity investors makes the same investment at the same time, one of them normally leads in the final negotiation of the deal's terms and conditions. The lead Investor usually takes the largest piece of the deal, but not always. VC investors in prior rounds almost never lead a follow-on round.

Legal Jargon

There is a lot of this in private equity. See Lecture Note, “*Legal Documentation*.”

Leverage

The proportion of debt in the capital structure is “financial leverage.” Changes in the market value of the firm have a disproportionate (leverage) effect on the market value of the equity, because there is a fixed amount of value for the debt. For example, assume a company’s capital structure is 50% debt, 50% equity -- worth \$1,000 in total. Debt is worth \$500, so is the equity. The market value of the firm now doubles to \$2,000. Debt still is worth \$500, but the equity value has tripled to \$1,500. The math works on the downside, too.⁴

Leveraged Buyout

See Buyout, above.

Luck

“I would rather be lucky than smart,” -- standard philosophy among VC investors.

M&A

Mergers and Acquisitions – buying and selling whole companies. Many investment bankers give M&A advice for a living, until they burn out at age 35. Thereafter, they often try to become private equity buyout investors, if they can raise a fund.

Management Buyout

See Buyout, above.

NOL’s

Net Operating Loss -- tax carryforward. Provides a tax shield for cash flow in many buyouts and turnarounds. Difficult to model. See *Simplex 2002* for an example of the math.

Operating Cash Flow

Cash earnings of a company, equal to net income plus depreciation and amortization.

Options

A contract to buy stock in the future, at some specified time or during some specified time period, at a price agreed today. Qualified Incentive Options, available for employees of a company, may receive favorable income tax treatment (long term capital gains), provided that the Company grants no more than \$100,000 worth to that person in any one year. Proper accounting treatment for stock options has become a hot topic in recent years.

Paper

Debt instruments issued by the buyer -- to pay for all or part of a buyout. Most sellers prefer cash and a clean exit. Proceeds received in Paper involve more risk for the seller because the buyer may be unwilling or unable to pay off this debt when the time comes.

⁴ Leverage also can mean “operating leverage.” High operating leverage means a company has a high proportion of fixed costs. Changes in sales have a disproportionate (leverage) effect on operating profits.

Paper Profit

The accounting or theoretical gain on an equity or other investment before the investor actually sells the position. “Cash is King” in private equity. Paper profits can come and go in a heated rush. Experienced VC investors tend not to rely on their paper profits.

Pari-Passu

Equal to the other, in the right to receive proceeds. Bank lenders may share collateral on a pari-passu basis (all share proportionately in the proceeds of any asset sales).

Passive Investors

Investors who invest their money, then go sit on the beach or watch office ticker tapes. Passive investors do not try to influence management of their portfolio companies.

Poison Pills

Legal techniques employed by management of target companies to avoid hostile takeovers and the loss of their jobs. Techniques often include the automatic issuance of a boatload of new stock to existing shareholders at a very cheap price, in event of a hostile bid.

Post-Money

The value of an entire venture company, or the price per share, *after* VC investors invest new money in a company. Analysts usually assume that new money will increase the value of the firm by the amount of new investment. Pre-Money + Money = Post-Money.

Pre-Money

The value of an entire venture company, or the price per share, *before* VC Investors invest new money in a company. The art of pre-money equity valuation involves experienced judgment, stock market research, some simple math and an overall feel for the situation.

Price/Earnings Ratio or P/E Ratio

Market value of common stock, divided by the earnings attributable to the common stock. Or, the market price a one share of common divided by the Earning Per Share. See the Lecture Note, “*Financial Statement Analysis and Ratios*” for more detail.

Pricing

Setting an agreed value for all the equity of a company, usually in connection with selling new equity to private investors or to the public in an IPO. After parties agree about the value of the whole firm, they determine the price per share of new stock based upon the percentage of total ownership that is for sale.

Privatization

A type of very large buyout deal where a government is the seller. These are frequent opportunities in emerging markets. Sometimes, it involves a turnaround situation as well. This type of investment often contains highly unusual risks and challenges.

Pro Rata

A proportional share of an obligation or an investment. For example, an investor with a 30% ownership stake, taking a pro rata share of a new \$10 million investment in the company, would invest \$3 million or 30%.⁵

Representations

Facts about the company and its circumstances that management or sellers say are true in the legal documentation of a private equity deal. Same as Warranties.

Retainer

A cash fee paid to legal or financial advisors to secure their engagement to help a company complete a deal. The Company pays the fee at the start of a professional assignment.

Road Show

Company management travels, to pitch a capital-raising deal to potential investors.⁶

Rule 144

A legal requirement promulgated by the Securities and Exchange Commission that restricts investors in the public sale of stock (for two years after a private equity transaction).

Quoted Company

A company with publicly traded securities.

Seller Paper

In buyouts, the seller often takes back a debt instrument issued by the company itself as part of the sale proceeds. Seller paper frequently is junior or junk debt, subordinated in priority to bank loans and other senior debt in a LBO.

Situation

A general term that refers to any pending business deal. Investors, for example, will say they are looking at “a situation” in Mexico, and at an interesting buyout situation in Ohio.

Startup

A new venture that does not have any sales, yet. Includes Seed and R&D situations. Highest risk category for VC investors, many of whom will not invest this early in a new company’s life. About 90% of all VC firms (by amount of \$ available) will not do Startups.

Strike Price

The price at which one may buy shares of stock under an option or warrant contract.

⁵ Creditors all must pay their *pro rata* share of the cost of oats, if the repossessed collateral is a race horse.

⁶ War Story: There once was a multiple choice test that went with these Lecture Notes. For the definition of “road show”, one student actually chose, “A display of highway alternatives for State transportation officials.”

Stumble

A negative event or series of poor results in a company's operation. For example, sales go down when management had said that sales will go up -- is a stumble. Recovery from a stumble in private equity is difficult unless the Board replaces management. An attempt to get things moving again after a stumble is a "Restart."

Success Fee

A fee paid to financial intermediaries, such as a broker or bank, upon the successful consummation of a deal, payable at the closing. Also called the deal's "Contingent Fee." In raising private equity capital, an agent can earn a Success Fee equal to 5%-10% of the money so raised. These are among the largest fees, in terms of percentage of the deal, that an intermediary can earn in the world of finance. (There is a high risk of not closing.)

Syndication

Investors club together to make an investment larger than any single investor wants to do for its own book. A lead investor often first finds the opportunity and may speak for the whole deal, subject to finding other investors to join in.

Take Back

The seller receives something other than cash for a portion of the value of company sale. Usually a seller "takes back" paper, a debt instrument with special terms and conditions.

Turnaround

A troubled company that needs to improve its operations or financial structure, or both. Some investors specialize in turnaround situations. They bring in new management and restructure the company's debt and equity -- to a set of more manageable obligations.

Underwriter

An investment bank, or syndicate of investment banks, that sells new (primary) or existing (secondary) shares of stock to the public. Underwriters technically buy all the primary or secondary stock from the seller in an underwritten stock offering. They then re-sell the shares to institutional and public investors on the same day. Underwritten stock offerings can be fairly risky capital market transactions. Investment banks charge a fat fee.

Upside

The chances of a positive outcome from an investment, such as making a profit equal to ten times the amount of original investment. Investors try to maximize their upside potential.

Vesting Period

A period of time that must pass before management becomes entitled to full ownership of stock or their stock options. Full vesting (legal ownership) may also depend upon the achievement of stated business objectives, such as a level of sales or profit growth.

Vorpal Blade

A mythical sword of ultimate power, critical to survival in any battle with the Jabberwock. Solar credits may be useful in any search for a vorpal sword.

Warrant

The same economics as an option -- but typically issued to outside investors, whereas companies usually issue stock options to employees. The holder can sell warrants without exercising them, resulting in lower taxes as a long term capital gains (vs. ordinary income).

Warranties

Same as legal Representations.⁷

Xenophobia

Distrust of foreign investors among family-owned companies in emerging markets.

Zero

In private equity, investment returns that result from an unwillingness to take any risks.

⁷ There must be some sort of a historical legal difference between Representations and Warranties, but you will have to ask a legal scholar.

A Revised Version of Investment and Financial Jargon Summer 2002

BROKER: What my financial advisor has made me.

BULL MARKET: A random market movement causing investors to mistake themselves for financial geniuses.

“BUY, BUY”: A flight attendant making market recommendations as you step off the plane.

CASH FLOW: The movement your money makes as it disappears down the toilet.

CEO: Chief Embezzlement Officer.

CFO: Corporate Fraud Officer.

EBIT: Earnings Before Irregularities and Tampering.

EBITDA: Earnings Before I Tricked Damn Auditor.

EPS: Eventual Prison Sentence.

FINANCIAL PLANNERS: People who actually remember to take money when they run to the 7-11 for toilet paper and cigarettes.

FRS: Fantasy Reporting Standards.

INSTITUTIONAL INVESTOR: Past year investor who's now locked up in a nuthouse.

MARKET CORRECTION: The day after you buy stocks.

MOMENTUM INVESTING: The fine art of buying high and selling low.

NAV: Normal Anderson Valuation.

P/E RATIO: The percentage of investors wetting their pants as the market keeps crashing.

P/E: Parole Entitlement.

PROFIT: Religious person who talks to God

STANDARD & POOR: Your life in a nutshell.
