

# Private equity

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In finance, **private equity** is an asset class consisting of equity investments in companies that are not traded on a public stock exchange. Investments typically involve a transformational, value-added, active management strategy.

Private equity firms generally receive a return on their investments through one of three ways: an IPO, a sale or merger of the company they control, or a recapitalization. Unlisted securities may be sold directly to investors by the company (called a private offering) or to a private equity fund, which pools contributions from smaller investors to create a capital pool.

Some examples of organizations owned by private equity firms are The Automobile Association, Jimmy Choo Ltd and Boots the Chemist.

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## History and evolution

The seeds of the private equity industry were planted in 1946 when the American Research and Development Corporation (ARD) decided to encourage private sector institutions to help provide funding for soldiers that were returning from World War II. While the ARD had difficulty stimulating any private interest in the enterprise and ended up disbanding, they are significant because this marked the first recognized time in financial history that an enterprise of this type had been formed. In addition, they had an operating philosophy that was to become significant in the development of both private equity and venture capital: they believed that by providing management with skills and funding, they could encourage companies to succeed and in doing so, make a profit themselves. During the course of their unsuccessful journey, ARD did succeed in raising approximately \$7.4 million, and they did have one rousing success; they funded Digital Equipment Corporation (DEC). By the 1970s such private participation had permeated into the private enterprise formation, but till in the late 1970s, the

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task was being largely carried out by investment arms of a few wealthy families, such as the Rockefellers and Whitneys..<sup>[1]</sup> In the 1980's, FedEx and Apple were able to grow because of private equity or venture funding, as were Cisco, Genentech, Microsoft, Avis, Beatrice Foods, Dr. Pepper, Gibson Greetings, and McCall Patterns.<sup>[2]</sup> Despite these successes, through a series of "debt-financed leveraged buy-outs (LBOs)" of established firms, the PE firms were being seen with acrimony and being casted as irresponsible corporate raiders- as a threat to the free capitalist structure. The extreme example of this phenomenon is described in the bestselling book,<sup>[3]</sup> where the two PE firms Forstmann Little and Kohlberg Kravis Roberts, were described as "Barbarians at the Gate" for their aggressive \$25 billion pursuit for RJR Nabisco.

## Types

Private equity investments can be divided into the following categories:

- **Venture capital:** an investment to create a new company, or expand a smaller company that has undeveloped or developing revenues;
- **Buy-out:** acquisition of a significant portion or a majority control in a more mature company. The acquisition normally entails a change of ownership;
- **Special situation:** investments in a distressed company, or a company where value can be unlocked as a result of a one-time opportunity (Changing industry trends, government regulations etc.);
- **Merchant banking:** negotiated private equity investment by financial institutions in the unregistered securities of either privately or publicly held companies.<sup>[4]</sup>

## Features

Considerations for investing in private equity funds relative to other forms of investment include:

- Substantial entry costs, with most private equity funds requiring significant initial investment (usually upwards of \$1,000,000) plus further investment for the first few years of the fund.
- Investments in limited partnership interests (which is the dominant legal form of private equity investments) are referred to as "illiquid" investments which should earn a premium over traditional securities, such as stocks and bonds. Once invested, it is very difficult to gain access to your money as it is locked-up in long-term investments which can last for as long as twelve years. Distributions are made only as investments are converted to cash; limited partners typically have no right to demand that sales be made.
- If a private equity firm can't find suitable investment opportunities, it will not draw on an investor's commitment. Given the risks associated with private equity investments, an investor can lose all of its investment if the fund invests in failing companies. The risk of loss of capital is typically higher in venture capital funds, which invest in companies during the earliest phases of their development, and lower in mezzanine capital funds, which provide interim investments to companies which have already proven their viability but have yet to raise money from public markets.
- Consistent with the risks outlined above, private equity can provide high returns, with the best private equity managers significantly outperforming the public markets.

For the above mentioned reasons, private equity fund investment is for those who can afford to have their capital locked in for long periods of time and who are able to risk losing significant amounts of money. This is balanced by the potential benefits of annual returns which range up to 30% for successful funds.

## Private equity fundraising

Private equity fundraising refers to the action of private equity firms seeking capital from investors for their funds. Typically an investor will invest in a specific fund managed by a firm, becoming a limited partner in the fund, rather than an investor in the firm itself. As a result, an investor will only benefit from investments made by a firm where the investment is made from the specific fund that they have invested in.

The majority of investment into private equity funds comes from three sources:

- Institutional investors. The most prolific investors into private equity funds in 2006 were public pension funds and banks and financial institutions, which together provided 40% of all commitments made globally according to data from London-based Private Equity Intelligence Ltd. Other prominent groups investing in private equity include corporate pension plans, insurance companies, endowments, family offices and foundations.
- Fund of funds. These are private equity funds that invest in other private equity funds in order to provide investors with a lower risk product through exposure to a large number of vehicles often of different type and regional focus. Fund of funds accounted for 14% of global commitments made to private equity funds in 2006 according to Private Equity Intelligence Ltd.
- Individuals with substantial net worth. This is often required by the law as well, since private equity funds are generally less regulated than ordinary mutual funds. For example in the US, most funds require potential investors to qualify as accredited investors, which requires \$1 million of net worth, \$200,000 of individual income, or \$300,000 of joint income (with spouse) for two documented years and an expectation that such income level will continue.

As fundraising has grown over the past few years, so too has the number of investors in the average fund. In 2004 there were 26 investors in the average private equity fund, this figure has now grown to 42 according to Private Equity Intelligence Ltd.

It is also worth noting that the managers of private equity funds themselves will also invest in their own vehicles, typically providing between 1–5% of the overall capital.

Often private equity fund managers will employ the services of external fundraising teams known as placement agents in order to raise capital for their vehicles. The use of placement agents has grown over the past few years, with 40% of funds closed in 2006 employing their services according to Private Equity Intelligence Ltd. Placement agents will approach potential investors on behalf of the fund manager, and will typically take a fee of around 1% of the commitments that they are able to garner.

The amount of time that a private equity firm spends raising capital varies depending on the level of interest amongst investors for the fund, which is defined by current market conditions and also the track record of previous funds raised by the firm in question. Firms can spend as little as one or two months

raising capital where they are able to reach the target that they set for their funds relatively easily, often through gaining commitments from existing investors in their previous funds, or where strong past performance leads to strong levels of investor interest. Other managers may find fundraising taking considerably longer, with managers of less popular fund types (such as European venture fund managers in the current climate) finding the fundraising process more tough. It is not unheard of for funds to spend as long as two years on the road seeking capital, although the majority of fund managers will complete fundraising within nine months to fifteen months.

Once a fund has reached its fundraising target, it will have a final close. After this point it is not normally possible for a new investor to invest in the fund, unless they were to purchase an interest in the fund on the secondary market.

## Size of industry

Nearly \$135 billion of private equity was invested globally in 2005, up a fifth on the previous year due to a rise in buyouts as market confidence and trading conditions improved. Buyouts have generated a growing portion of private equity investments by value, and increased their share of investments from a fifth to more than two-thirds between 2000 and 2005. By contrast, the share of early stage or venture capital investment has declined during this period. Private equity fund raising also surpassed prior years in 2005 and totaled \$232 billion, up three-quarters on 2004.

Prior to this, after reaching a peak in 2000, private equity investments and funds raised fell in the next couple of years due to the slowdown in the global economy and declines in equity markets, particularly in the technology sector. The fall in funds raised between 2001 and 2003 was also due to a large excess created by the end of 2000 of funds raised over funds invested.

The regional breakdown of private equity activity shows that in 2005, North America accounted for 40% of global private equity investments (down from 68% in 2000) and 52% of funds raised (down from 69%). Between 2000 and 2005, Europe increased its share of investments (from 17% to 43%) and funds raised (from 17% to 38%). This was largely a result of strong buyout market activity in Europe. Asia-Pacific region's share of investments increased from 6% to 11% during this period while its share of funds raised remained unchanged at around 8%.<sup>[5]</sup>

The biggest fund type in terms of commitments garnered was buyout, with 188 funds raising an aggregate \$212 billion. So-called mega buyout funds contributed a significant proportion of this amount, with the ten largest funds of 2006 raising \$101 billion alone—23% of the global total for 2006. Other strong performers included real estate funds, which grew 30% from already strong 2005 levels, raising an aggregate \$63 billion globally. The only fund type to not perform so well was venture, which saw a drop of 10% from 2005 levels.

In terms of the regional split of fundraising, the majority of funds raised in 2006 were focusing on the American market, with 62% of capital raised in 2006 focusing on the US. European focused funds account for 26% of the global total, whilst funds focusing on Asia and the Rest of World account for the remaining 11%.

Venture capital is considered a subset of private equity focused on investments in new and maturing companies.

Mezzanine capital is similar class of alternative investment focused on structured debt securities in private companies.

## Private equity fund performance

In the past the performance of private equity funds has been relatively difficult to track, as private equity firms are under no obligation to publicly reveal the returns that they have achieved from their investments. In the majority of cases the only groups with knowledge of fund performance were investors in the funds, academic institutes (as CEPRES Center of Private Equity Research) and the firms themselves, making comparisons between various different firms, and the establishment of market benchmarks to be a difficult challenge.

The introduction of the Freedom of Information Act (FOIA) in the United States and other countries such as the UK in the early 21st Century, has led to performance data for the industry becoming more readily available. It is also possible to view private equity performance data directly on the websites of certain investors.

The performance of the private equity industry over the past few years differs between funds of different types. Buyout and real estate funds have both performed strongly in the past few years in comparison with other asset classes such as public equities, certainly a factor in the bumper fundraising that both have enjoyed of late. In contrast other fund types such as venture have not shown such a strong overall performance. Manager selection in the private equity industry is definitely a vital factor for any investor seeking exposure to the market, with the performance of the top and bottom quartile managers varying dramatically, especially so in the high-risk venture capital world, and less so with real estate funds for example.

However, it is challenging to compare private equity performance to public equity performance. One method is the Long and Nickels excess IRR measure, which is not reliable. Another method which is gaining ground in academia is the public market equivalent or profitability index. The profitability index tells you how much you would have to invest in the public market (given its returns) to earn the same as you did from your private equity portfolio. See Phalippou and Gottschalg's 2007 paper, "The Performance of Private Equity"<sup>[6]</sup> for an overview of the profitability index.

## Liquidity in the private equity market

The private equity secondary market (also often called private equity secondaries) refers to the buying and selling of pre-existing investor commitments to private equity and other alternative investment funds. Sellers of private equity investments sell not only the investments in the fund but also their remaining unfunded commitments to the funds. By its nature, the private equity asset class is illiquid, intended to be a long-term investment for buy-and-hold investors. For the vast majority of private equity investments, there is no listed public market; however, there is a robust and maturing secondary market available for sellers of private equity assets.

Driven by strong demand for private equity exposure, a significant amount of capital has been committed to dedicated secondary market funds from investors looking to increase and diversify their private equity exposure.

## Further reading

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## See also

- Investment banking
- Financial sponsor
- Leveraged buyout
- Management buyout
- Mergers and acquisitions
- Mezzanine capital
- Private equity secondary market
- Private investment in public equity
- Private equity fund
- Taxation of Private Equity and Hedge Funds
- Venture capital
- Gramm-Leach-Bliley Act

## References

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2. ^ *Private Equity: Past, Present, Future*, by Sethi, Arjun May 2007, accessed October 20, 2007.
3. ^ Barbarians at the Gate: The Fall of RJR Nabisco.
4. ^ Merchant Banking: Past and Present
5. ^ [http://www.ifsl.org/uploads/CBS\\_Private\\_Equity\\_2006.pdf](http://www.ifsl.org/uploads/CBS_Private_Equity_2006.pdf)
6. ^ Performance of Private Equity Funds

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