

An Introduction to Private Equity

Raising equity for companies via private equity (PE) route has been one of the most important aspects of the investment banking services after mergers and acquisitions. Individuals, aristocrats, syndicates and merchant banks have been providing a form of PE for centuries. Professional private equity investing dates back to 1946, to the launch of American Research and Development Corporation, a \$4 million fund that pooled individual and institutional money to invest in private companies.

PE is a major component of the alternative investments universe and is an established asset class within many institutional portfolios. In India, sums committed to private equity funds have increased dramatically over the last ten-twelve years.

Private Equity is a form of investment in equity capital of a company that is not quoted on a public exchange. Obtaining PE is very different from raising debt or a loan from a lender, such as a bank. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of your success or failure.

PE is All About Capital and More Than Just Capital

Two important features of private equity investing include—

It's All About Capital...

Private equity investing means putting capital into a business to expand, develop new products or fund changes to ownership and management. Private equity investors do more than buy the rights to share in a company's return – they provide working capital.

...And More Than Just Capital

PE investors generally provide their capital in exchange for a sizeable stake in the business. They also invest their expertise – in management, finance, marketing, strategic direction and networks. By exercising some control through board seats and management agreements, PE investors can protect and grow their investments. This alignment of interests and the ability to add value to the business often means that PE investors can generate higher returns than those available from traditional 'hands-off' equity investing.

Different Equity Funding Stages

Equity investing is often divided into the broad categories described below.

Maturity of Company				
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Seed Stage	Start-up Stage	Expansion Stage	Replacement Capital	Buyout
Angel Investments		VC & PE	Private Equity	

Seed Stage

Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.

Start-Up Stage

Financing for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially and will not yet be generating a profit.

Expansion Stage

Financing for growth and expansion of a company, which is breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital. This stage includes bridge financing and rescue or turnaround investments.

Replacement Capital

Purchase of shares from another investor or to reduce gearing via their financing of debt

Buyouts

A buyout fund typically targets the acquisition of a significant portion or majority control of businesses, which normally entails a change of ownership. Buyout funds ordinarily invest in more mature companies with established business plans to finance expansions, consolidations, turnarounds and sales, or spinouts of divisions or subsidiaries. Financing expansion through multiple acquisitions is often referred to as a "buy and build" strategy. Investment styles can vary widely, ranging from growth to value and early to late stage. Furthermore, buyout funds may take either an active or a passive management role.

Private Equity vs. Venture Capital

People normally take private equity and venture capital as one and the same thing. Though identical, the two industries are quite different. Venture capital involves minority investments in firms at early stages of development, whereas PE funds make majority investments in matured companies. PE can involve different categories of investors depending on risk profile, stage of funding and investment size.

	Stage	Features
Angel Investor	Idea	- High net-worth individuals who have been successful entrepreneurs - Invest in new ideas which have not been proven yet - Take significant risks and invest a lot of time in mentoring and guidance - Driven by entrepreneurial spirit
Venture Capital	Start-Up	- Provide funds for early stage companies - Typically made for scaling up operations by developing or launching new products or services - Provide entrepreneurial support and guidance in developing business strategy
Private Equity	Growth/ Mature	- Typically invests in well established business with a proven track record - Large funds for expansion and growth - Take well defined risks - Have reasonably good view of exit strategy

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Chapter 2, Para 2.4, *Investment Banking: The Dream Begins* (4th Edition)