Private equity and venture capital – a lexicon

"Private equity", as the term suggests, involves investment of equity capital in private businesses. There are three broad categories of investment within private equity:

– ***Early stage investment*** (sometimes called "venture investment") – this is investment in early stage or start-up businesses, usually engaged in life sciences research or technology development activities. Here, the investor ("the VC") would usually take a minority equity stake (ie less than 50% of the equity shares) in the business as part of a syndicate of venture investors; and the aim of the investment is to provide funding for development or research expenditure through a series of investment "rounds". Progress and prospects are re-assessed ahead of the provision of further funding.

– ***Growth capital (or development capital) investment*** – this involves the provision of capital to accelerate the growth of established businesses and generally involves the VC taking a minority equity position. It is a "product" suited to a diverse range of growth opportunities, including acquisitions, increasing production capacity, market or product development, turnaround opportunities, shareholder succession and change of ownership situations.

– ***Buyout investment*** – this involves the purchase of an existing independent business or subsidiary or division of a corporate group from its current owners. This category of investment includes management buyouts, management buy-ins, institutional buyouts, etc. Here, the equity in the post buyout business is usually shared between the management team and the VC, with the VC usually holding a majority stake. The finance for the buyout would generally comprise around 60% of senior and mezzanine debt (usually provided by banks and mezzanine providers), with substantially all of the balance of the purchase price coming from the VC and a relatively small amount coming from the management team. In order to reflect the mismatch between the equity finance provided by the VC and that provided by the management team and the equity stake taken by each in the underlying business, a large part of the VC's finance is generally provided in the form of redeemable preference shares or shareholder loans.

Investment objective Like any other investment, the objective of the VC is to earn attractive returns on its investment commensurate with the risk being taken. The returns come either in the form of income (interest, dividends or fees) or capital gains. The contrast with investment in quoted companies is that the VC will usually prefer to crystallise its capital gain through a trade sale (ie a sale to a corporate purchaser) or flotation on the public markets of the underlying business. This preference tends to make private equity investment medium to long term in nature, since time is required to implement the value growth strategy for the business and there will also be a wish to optimise the timing of the "exit".

The investment lifecycle The investment lifecycle for an investment can be broken down into five distinct phases, with each involving significant resource and capability on the part of the VC:

– ***Origination*** – the ability to access and create investment opportunities is critical to the VC's business model.

– ***Developing and validating the investment case*** – this phase involves capability in the areas of judgment, knowledge and experience within the particular business area in which the opportunity lies; building a management team and working with it to develop the value growth strategy; consideration of the exit strategy; and "due diligence" on all significant assumptions and inputs to the investment case.

– ***Structuring and making the investment*** – this phase involves financial structuring, negotiation and project management skills on the part of the VC. Relationships with banks, mezzanine finance providers, intermediaries and others are also important.

– ***Implementing the value growth strategy*** – this phase involves "actually making it happen", delivering value growth between making the investment and exit. If the strategy involves corporate acquisitions or mergers, restructuring the business, achieving growth in turnover or operating profits, the VC would need to have the required capability to ensure these are achieved. As important is the ability to assess and strengthen the management team as the life cycle proceeds – this might involve having access to a pool of management talent in order to match a particular need to a particular management skill-set.

– ***Exit*** – this phase generally involves a trade sale or flotation of the underlying business. Exit prospects and strategy should generally be reviewed on an ongoing basis during the investment's life – and the sale or flotation itself requires resource and capability from the VC, since both are lengthy and complex processes.

Types of investment vehicle The predominant vehicle in the industry is the independent, private, fixed-life, closed-end fund, usually organised as a limited partnership. These funds typically have a fixed life of 10 years. Investments generally consist of an initial commitment of capital which is then drawn down as the investment manager finds investment opportunities. Capital is returned to the investor via earnings distributions and sales of investments.

Some investment vehicles are organised as captive or semi-captive funds. A captive fund invests only for the interest of its parent organisation (which may be a bank or investment bank, insurance company, university, or whatever). A semi-captive fund mixes capital from both outside investors and the parent organisation. Both captive and semi-captive funds tend to be "evergreen" in nature – income from investments and proceeds received on the realisation of investments are substantially retained for further investment rather than being returned to investors.

There are also a limited number of private equity investment companies, such as 3i, whose shares are listed on a stock exchange. These tend to be evergreen in nature and offer investors a relatively liquid exposure to private equity.

Drivers of private equity investment Some of the main drivers giving rise to investment opportunities are as follows:

– ***Stock market conditions and M&A activity levels*** – a strong stock market acts in many ways as an "engine" for private equity, since it allows acquisitive listed companies to purchase businesses at attractive prices and also is more receptive to businesses seeking a listing. The ability of the VC to "exit" at reasonably high values is a key part of the investment model, and exit assumptions will be a key input to the pricing parameters at the time of investing. In addition, strong activity levels in the M&A market (which will often follow from good stock market conditions) tend to provide a source of investment opportunities when the acquiring group disposes of the unwanted parts of the business acquired.

– ***Restructuring by large corporate groups*** – as corporate groups change strategic direction or focus on core activities, they will often seek to sell unwanted or non-core subsidiaries or divisions, providing a good source of buyout opportunities.

– ***Entrepreneurial culture*** – this is to do with the eagerness, across a society, of individuals to start up or grow businesses or to give up a secure corporate job for the opportunity to run or manage an independent business.

– ***Growth strategies*** – the pursuit of profits by businesses will often involve the use of growth strategies. Whether the strategy is to grow organically or through acquisition, there will usually be a funding requirement, which can be met through the provision of growth capital.

– ***Regulatory factors*** – regulatory factors will often act to force corporations to sell off business units or to limit or restrict courses of action by parties operating in the complex world of business. Additionally, regulatory factors can act to incentivise certain types of investment or courses of action. Either way, regulation can give rise to investment opportunity for private equity.

– ***Technological developments and expenditure on information technology*** – both of these factors act as engines for investment in the early stage technology area, as entrepreneurs seek to exploit the development and research opportunities arising.

– ***Succession issues*** – especially in family-owned businesses, succession issues can give rise to investment opportunities.