

# Private Equity

## What is Private Equity?

Private equity is a broad term which commonly refers to an investment where ownership of the underlying asset is in private hands and is not quoted or freely tradeable on a public stock market. Private Equity is, in effect, the term used when a group of individual investors pool funds in order to make a combined investment in one or more business ventures, which obviously they hope to sell for a profit. Private equity can also refer to the manner in which the funds for the investment have been raised, namely by subscription by private individuals or business acquisitions via introduction, as opposed to the public markets. Private equity firms were commonly misunderstood to invest in assets which were not in the public market. However this is not necessarily the case – larger private equity firms such as KKR and Blackstone also invest in companies listed on public exchanges, usually with a view to restructuring the company or to buying it completely and taking it private. Alliance Boots is a good example of a major plc being taken over by private equity.

## How does a Private Equity Fund work?

Private equity funds are the pools of capital invested by private equity firms. Although other structures exist, private equity funds are generally organized as either a limited partnership or limited listed company which is controlled by the private equity firm that acts as the general partner. The limited partnership is often called the ‘Fund,’ and the general partners are sometimes designated as the ‘Management Company’.

The fund obtains capital commitments from individuals or institutions referred to as ‘qualified investors’, such as pension funds, financial institutions and wealthy individual investors. Each of these commit a minimum level of capital to the fund. This commitment of capital is usually binding, even if not all of it is needed for immediate investment.

These investors become passive limited partners in the fund partnership and at such time as the general partner identifies an appropriate investment opportunity, it is entitled to ‘call’ the required equity capital at which time each limited partner funds a pro rata portion of its commitment. All investment decisions are made by the General Partner which also manages the fund’s investments (commonly referred to as the ‘portfolio’). Private equity funds typically control management of the companies in which they invest, and often bring in new management teams that focus on making the company more valuable.

## Why invest in Private Equity?

Private Equity can provide high returns, with the best private equity managers significantly outperforming the public markets. Similarly there is a real danger of picking the wrong manager – the differences in returns between the best and worst private equity funds can be far greater than in traditional long only equity funds. And, as we have already stated, getting your money out can be an issue.

### Points to consider

- Substantial entry costs, with most private equity funds requiring significant initial investment (usually upwards of £100,000) plus further investment for the first few years of the fund called a 'drawdown' but much larger sums for the largest firms.
- Investments in limited partnership interests (which is the dominant legal form of private equity investments) are referred to as 'illiquid' investments as, once invested, it is very difficult to gain access to your money as it is locked-up in long-term investments, typically ten to 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 the private equity firm can't find good investment opportunities, they will not draw on the investors' commitment, hence you can be in cash for a while. Given the risks associated with private equity investments, investors can lose all their money if the private-equity fund invests in failing companies. The risk of loss of capital is typically higher in venture capital funds, which back young companies in 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.

Most private equity funds are offered only to institutional investors and individuals of substantial net worth. This class of investors have far less regulatory protection due to their assumed knowledge of the risks associated with this type of investing.

For retail investors there is limited access to Private Equity. Investment trusts provide an alternative route into private equity for relatively small sums of money, although they bring the added complication associated with all listed investments of being volatile and frequently trading at a discount to the underlying net asset value.

### 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. Private equity fund-raising reached new record levels in 2006, with data from Private Equity Intelligence showing that a total of 684 funds worldwide achieved a final close over the course of 2006, raising an aggregate \$432 billion in commitments (Source: International Financial Services, London).