Private equity and venture capital – a lexicon

Definitions

"Private equity", as the term suggests, involves investment of equity capital in private businesses. More recently it has become as much associated with an investment style as it has with its more literal description.

3i's private equity activities cover:

Venture capital This is investment in "early-stage" or "late-stage" technology companies, Here, the investor ("the VC") typically takes a minority equity stake (ie less than 50% of the equity shares) in the business as part of a syndicate of VCs. "Early-stage" investments typically fund research or development expenditure and costs associated with building an organisation for a company which is pre revenue. "Late-stage" investments tend to fund the scaling up of a business once the model is proven for companies which are either pre or just making a profit. Both early and late-stage investing usually involves a number of "funding rounds".

Examples of venture capital investments can be found on pages 22 and 23.

Growth capital (or development capital) This involves the provision of capital to accelerate the growth of established businesses and generally involves the private equity investor ("PE investor") taking a minority equity position. It is a type of investment 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.

Examples of growth capital investments can be found on pages 18 and 19.

Buyouts This involves the purchase of an existing independent business or a subsidiary or division of a corporate group from its current owners. This category of investment includes management buyouts, management buy-ins, and institutional buyouts. Here, the equity in the post-buyout business is usually shared between the management team and the PE investor, with the PE investor 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 PE investor and a relatively small amount coming from the management team. In order to reflect the mismatch between the equity finance provided respectively by the PE investor and the management team and the equity stake taken by each in the underlying business, a large part of the PE investor's finance is generally provided in the form of redeemable preference shares or shareholder loans.

Examples of buyouts investments can be found on pages 14 and 15.

Quoted Private equity ("QPE") This involves the purchase of influential stakes in smaller quoted companies which have low liquidity in their shares, little analyst coverage and potential to grow significantly but are constrained by their current shareholding composition. The concept is that through taking a private equity value adding approach to these companies and working with management their prospects can be significantly improved.

Investment objective

Like any other investment, the objective of the PE investor 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 PE investor will usually prefer to crystallise its capital gain through a trade sale (ie a sale to a corporate purchaser), a sale to a financial purchaser or a 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 or PE investor:

Origination – The ability to access and create investment opportunities. This is a critical component of a PE investor's business model.

Developing and validating the investment case – In this phase the PE investor draws upon their knowledge, experience, commercial judgment and other capabilities to develop and validate their investment case. This might involve building a potential board and management team and working with them to develop the strategy for value growth and exit; as well as conducting "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 PE investor. Relationships with banks, mezzanine finance providers, intermediaries and others are also important.

Implementing the value creation plan This phase involves "actually making it happen", creating value 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 PE investor 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, a listing on a stock exchange or a sale to another private equity firm ("a secondary"). 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 PE investor, 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, for example, a bank or investment bank, insurance company, university). 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 more liquid exposure to private equity.

Infrastructure

3i also invests in infrastructure assets. These relate to investment in public service activities covering the range from "primary" investment, the building of a public service operation (eg a road, hospital or school), to "secondary" investment, which involves the operational scaling once the facilities are up and running and finally "tertiary" investments in mature infrastructure operations.