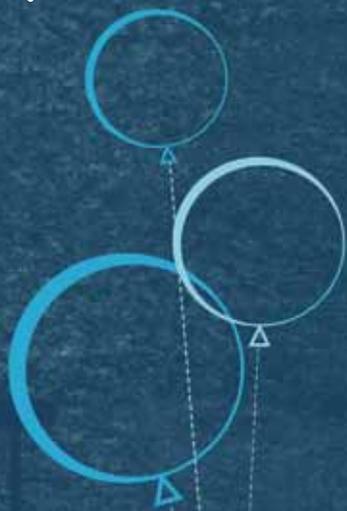


EVCA



The little book of
PRIVATE EQUITY



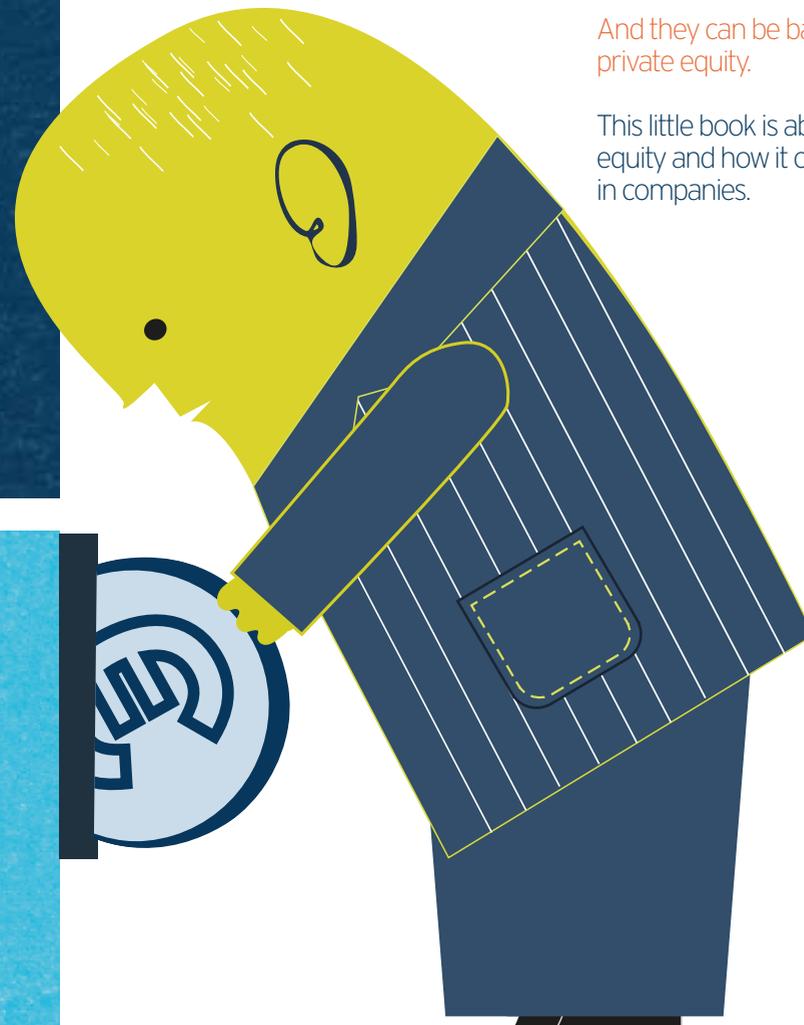
There are several ways that companies can be owned and can raise fresh capital for investment.

Companies can be state-owned. They can be owned by families or big businessmen and women.

They can be listed on a stock market (and so have thousands or sometimes more than a million individual and institutional owners).

And they can be backed by private equity.

This little book is about private equity and how it owns and invests in companies.



Companies come in all shapes and sizes.

So do private equity funds.

There are funds that invest in entrepreneurial start-ups that have just the germ of a business idea.

And there are funds that acquire established companies in old industries, with the aim of reviving their fortunes.

But most companies are in between the two extremes - these are 'small and medium-sized enterprises'. Most private equity investments, around 85%, are into SMEs.

In Europe, private equity firms are invested in 22,000 SMEs. It sounds like a lot. But there are more than 20 million European SMEs in total.

So what's different about the 22,000?



Private equity funds are very picky.

They are the talent scouts of company investment. They spend ages assessing the potential of companies, to understand their risks and how to mitigate them. They only allocate their private equity funds to companies with the 'X' factor.

That doesn't mean these companies have to be the best in their field.

Usually they are not.

Private equity just helps them get there.



Private equity is invested by fund managers. These also come in all shapes and sizes.

Some fund management firms are made up of just a handful of people, often former entrepreneurs themselves. Others are big institutions with a global network of business contacts and know-how.

But the idea is the same: to invest in a company and make it more valuable, over a number of years, before finally selling it to a buyer who appreciates that lasting value has been created.

These buyers might be large conglomerates and corporations, larger financial investors or stock market investors (through an initial public offering or IPO).

If the company is not much more valuable when it is sold - normally it needs to grow 8% or more every year of the investment - the fund manager doesn't get their reward (sometimes called 'carried interest').

This growth is quite difficult to achieve, and many fund managers don't ever manage it.

Stock market investing is much better known than private equity. But there are important differences in how private equity governs and controls companies.

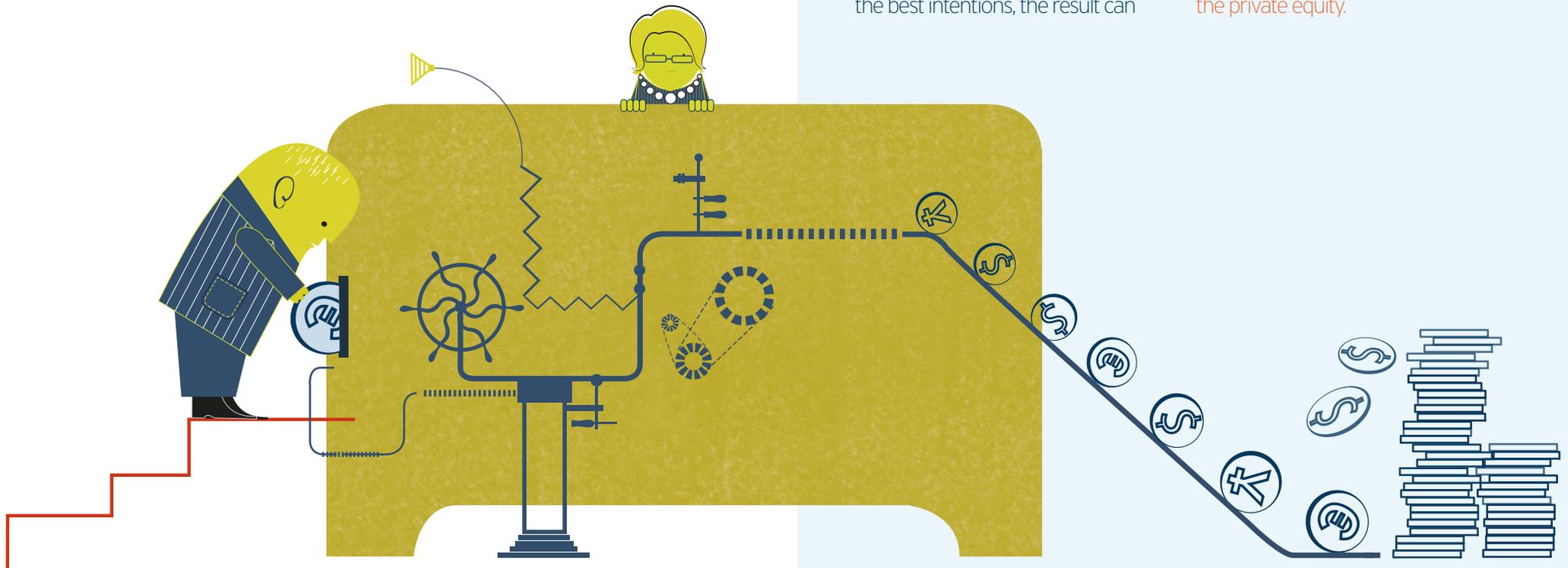
Since listed companies have so many owners, they can't all be involved in the running of the business. So the task is given to 'executives' who wield significant power, with reference to their disparate owners.

This system of executive stewardship severs the concept of management of businesses from their ownership (sometimes called 'the agency problem'). Even with the best intentions, the result can

be a misalignment of interest and sometimes excessive personal rewards despite poor performance.

In private equity, companies are owned by a small number of professional investors, through a chain of command that directly links value with reward, from company managers through to private equity fund managers, and back through to the fund.

Such clear accountability has many benefits. For instance, it gives comfort to potential lenders, allowing private equity-backed companies to attract relatively cheaper debt finance for their activities, alongside the private equity.



The way private equity funds are structured is the key to understanding how they invest in companies.

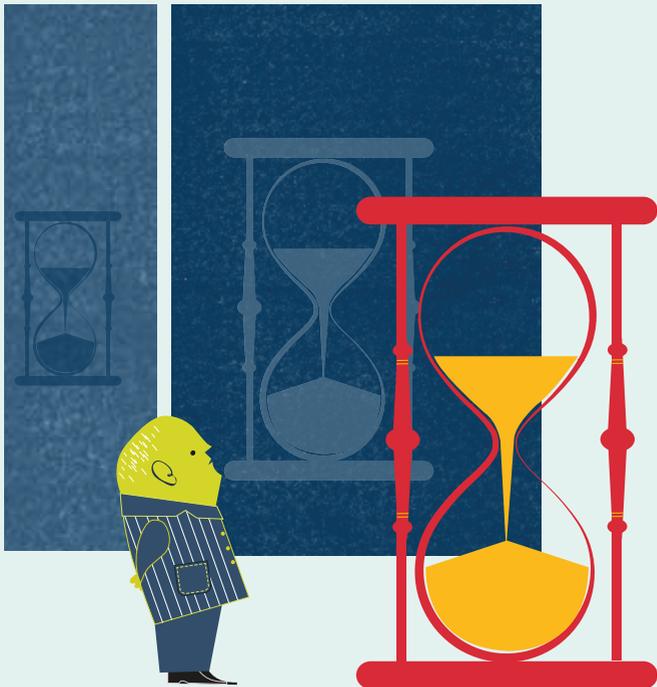
Commonly, private equity funds are 10-year limited partnerships.

That means the underlying investors into funds commit their money for a long time (in practice, well over a decade). They can't trade in and out easily. Such investments are viewed as 'illiquid'.

That means short-term performance is irrelevant. It is irrelevant to the company managers, the fund manager and the underlying investors, since none of them get remunerated for short-term performance.

Unlike in listed companies, where management-stewards receive bonuses based on annual performance, private equity rewards only come when an unrelated buyer sees greater value in a company than was originally paid for it.

Creating sufficient value typically takes up to five, or even 10, years.



So whose money is 'private equity'?

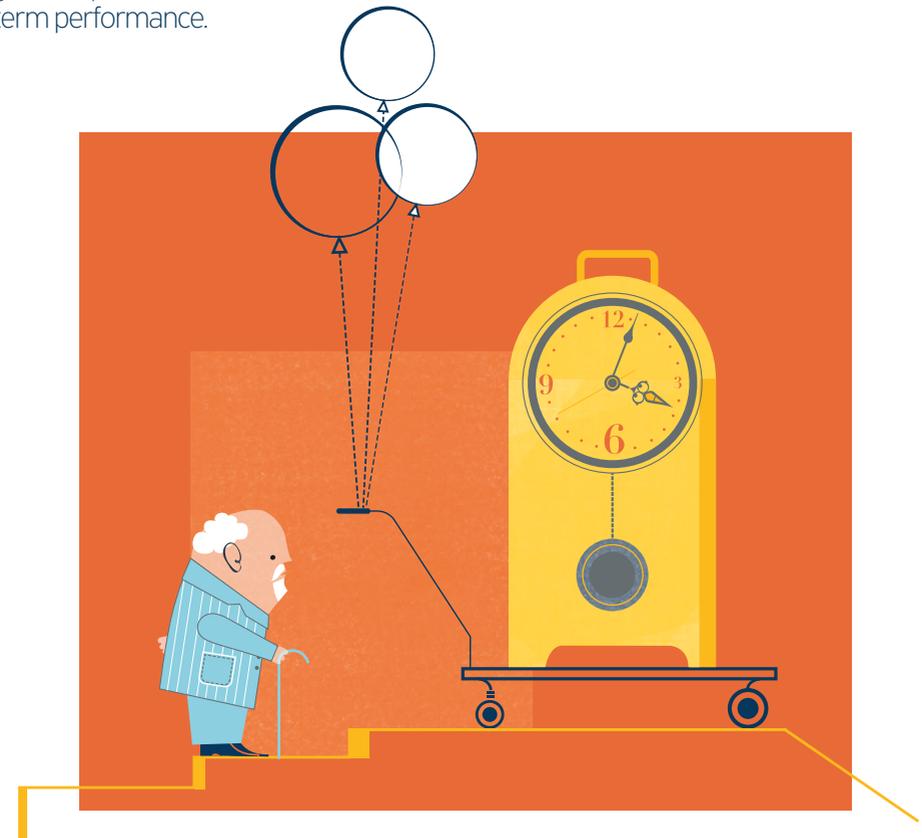
It's yours.

If you are part of a pension scheme, or if you have an insurance policy, it is very likely that part of that money has been invested into a private equity fund.

Pension fund managers like private equity because they only have one objective: to make sure you have enough money for your retirement. Like private equity fund managers, they don't care about short-term performance.

They recognise that instant access and the ability to change your mind often come at a price that is not worth paying.

By pooling their money with an experienced private equity fund manager, pension funds and insurance companies know that over the long term they are likely to achieve strong risk-adjusted returns for their stakeholders - people like you.



Like all industries, private equity has a lot of jargon that can be confusing.

Actually the reality is simple.

Let's get this out of the way first.

Hedge funds: nothing to do with private equity investment. Hedge funds are liquid (short-term) trading funds that can invest in all sorts of complex financial instruments.

They can invest in companies too, but can do so in order to bet against them.

Venture capital: this is when private equity is invested into young, entrepreneur-led, high-potential companies that are typically driven by technological innovation.

Enterprise capital: private equity investment into more established businesses that want to internationalise, professionalise or develop their products and services.

Buyouts: private equity can be used to acquire (or 'buy out') all or the majority of an established business. After that, the private equity method of ownership and governance kicks in.



Countries and citizens across the world face difficult economic times.

After the financial turmoil of the past decade, we need better and more stable mechanisms for achieving prosperity.

By creating lasting value through responsible company investment, private equity can contribute to making people's lives better.

Private equity is a relatively new industry in much of the world.

But it can play an important part in our future.

For more information about private equity, please contact us.

We would be happy to hear from you.

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EVCA is the European Private Equity & Venture Capital Association. Its mission is to create a more favourable environment for private equity and venture capital fundraising, investment and entrepreneurship.

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