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Private equity as an asset class

• Second Edition •

GUY FRASER-SAMPSON

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Private Equity as an Asset Class

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Private Equity as an Asset Class

Second Edition

Guy Fraser-Sampson

WILEY

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About the Author

Guy Fraser-Sampson draws on over twenty years' practical experience of Private Equity, having held a number of senior positions within the industry, including setting up and running for several years the international operations of the leading Fund of Funds manager Horsley Bridge. He previously lived in the Middle East while working with the Abu Dhabi Investment Authority. He now performs consultancy and executive training for investors, both LPs and GPs, around the world.

He has, for the last few years, designed and taught various modules at Cass Business School in the City of London. His module on Private Equity fund investing is believed to be the only course in the world which teaches the skills required to operate successfully as an LP. He also holds public workshops around the world on subjects including Private Equity, Investment Strategy, Asset Allocation and Alternative Assets. He is well known as a keynote speaker at conferences and investor meetings. He writes for a number of pension and investment publications, including his influential regular column in *Real Deals*.

Guy is the author of two titles in the Wiley Finance series: *Multi Asset Class Investment Strategy* and *Private Equity as an Asset Class*. Both have been Amazon best-sellers. The first edition of this book has been in the best-seller lists continuously for three years from publication, regularly featuring at number one, and its Chinese edition has the distinction of being the first book on Private Equity ever to be published in China. It has been adopted as the standard textbook on Private Equity by business schools around the world. It is also viewed as an indispensable reference and learning tool by investors and advisers.

In addition to numerous professional qualifications, Guy has an LLB with honours from King's College London, and an MBA majoring in finance from Warwick Business School. He lives in London.

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Introduction

It is only three years since this book was first published, and the need for a new edition after such a short space of time is an indication of how much the world has changed in the meantime. The financial crisis began to unfold when the book was just six months old, and the resulting credit crunch, together with a fall in both earnings and valuation multiples, has had a profound effect on the Buyout industry, particularly so in the case of the mega funds.

In the flight to liquidity which followed, many fund investors found themselves in what came to be dubbed 'Cash 22', needing to meet Capital Calls yet unable to generate the cash with which to do so from supposedly liquid assets. We will examine just what went wrong here, and note the potential buying opportunity which this represents in the secondary market.

Perhaps partly as a result of this, the Private Equity industry has begun to experience LP defaults, both actual and potential. By the end of 2009 we had also seen instances of LPs refusing to extend investment periods, and forcing fund size reductions. It is clear that the traditional cosy LP/GP relationship has changed, just as it did way back in 1989/90 and again in 2000/1. On both of those occasions, the cooling off was a short-term phenomenon and in both cases the industry went rapidly on to renewed growth. It is, as yet, unclear how long the current investor anxiety will last, and to what extent the industry can grow yet larger.

For growth has been the name of the game. You will see that it is strongly arguable that a whole new era of Private Equity began around 2001, one in which much, much more money has been poured into funds, and invested by them in companies. In fact, the world of Private Equity has changed so dramatically that what we see now is, in many cases, radically different from what went before. Not least has been the very significant increase in holding periods, and thus in investor payback periods, which has, in turn, been a major contributor to Cash 22.

So, much needed changing in the book, not least the guidelines to LPs as to how to plan a fund investment programme. The fact that this edition is half as long again as its predecessor indicates that much new material also needed to be included. Both secondary investing and Growth and Development Capital were now thought to merit their own chapters. Emerging markets do too, but sadly this is just not possible as yet given the paucity of really good and mature data. This is currently the most exciting area of Private Equity, and thus the most intriguing challenge for investors.

The opportunity has also been taken to update the data and expand the Glossary. In addition, some new graphics which have been used by the author to teach Private Equity, both in business school classes and in public workshops, have been included where these have been found to be useful as aids to understanding.

Some things, alas, have not changed. European Venture Capital remains an endangered species, an undeserving victim of investor prejudice. The economic model of GP remuneration remains largely intact. Misplaced LP loyalty continues to enable mediocre GPs to remain in business. The asset class as a whole continues to be neglected by many of the world's investors, most notably UK pension funds. Incidentally, while a full discussion of asset allocation lies beyond the scope of this book, we will at least note for the record the extent to which industry performance figures have been cynically manipulated and misrepresented by some pension consultants.

The fact that such crude and prejudiced views are still able to hold sway in some quarters points to the widespread lack of knowledge of Private Equity which still exists. Many investors, for example, continue to believe that Private Equity and mega Buyout are one and the same thing (whereas by number of funds the latter is only about 6% of the former). To add yet further to the confusion, many seem unable to distinguish between Private Equity funds and Hedge funds, and so a new section has been included in the book to address this problem. This is, of course, highly topical at the time of writing (late 2009) as we are currently seeing ill-judged regulation proposed by the EU which clearly demonstrates an inability to understand this distinction.

This, in turn, shows that the industry as a whole still has a lot of work to do in educating people around the world: educating those investors who are currently unable to take an informed view on the asset class; educating regulators to understand the different characteristics of different types of investment funds both within and outside the asset class; educating politicians, particularly in Asia, to see that Private Equity can safely be embraced, and can represent a powerful economic driver.

This is a challenge to which the industry can, and should, rise. Lack of transparency remains a problem, with many GPs, not just in emerging markets but even in places like America, still failing to register their data with the various providers. This is foolish and short-sighted. The more data sets which are available, and the more complex the ways in which they can be analysed, the more comfortable investors will feel about allocating money to the asset class. LPs can also play a role here, by insisting that an obligation to register fund- and company-level data should be a term of the Limited Partnership Agreement.

There is a challenge here, too, for some of the data providers, some of whose efforts have been overtaken by growth and change in the industry. It seems clear, for example, that growth, development and secondary activity all merit their own representation, and that the traditional classification of Venture activity into IT, Telecoms and Life Science is now outdated. Also, it seems to make little sense to find that sometimes holding periods to IPO are available, but not holding periods to sale or writing-off. Given the weight of accumulated data, none of these would be easy tasks to undertake, yet they seem more pressing with each year that passes.

It is vital that these challenges are met. Private Equity today is a much more complex animal than it was a decade or so ago, yet it remains surely the most fascinating of all asset classes.

Finally a stylistic point. Throughout this book both Private Equity as a whole and its constituent parts have been accorded capital letters, while in all other cases lower case is used. Thus 'Buyout' refers either to Buyout investing as a whole or to a type of fund, while 'buyout' refers to individual transactions.

1

What is Private Equity?

Perhaps never has an asset class been so misunderstood as Private Equity. There is a branch of philosophy which contends that all problems are essentially linguistic; that if one can only properly define precisely what one means then the problem effectively solves itself. All problems, they say, are problems of meaning, and usually arise because two people are using language in different ways.[1] While this may seem a rather extreme view, it does go a long way to explaining many, though not all, of the problems which currently arise when people try to understand Private Equity.

This has become of particular importance since the publication of the first edition in February 2007. There is no need to detail for the reader what has happened since then in the fields of finance and investment. Suffice it to say that events have prompted a wholesale re-evaluation of Private Equity, thrown into doubt some of the traditional approaches of both managers (GPs) and investors (LPs) and made necessary a new edition of this book. It is in the blizzard of media stories and political sound-bites that have bombarded investors and others during the last three years that the root cause of our problem may be found. Many of the authors of these comments did not, in fact, understand what they meant when referring to 'Private Equity', and this has, in turn, clouded attitudes and reactions around the world.

Many, for example, have behaved as though large and mega Buyout funds were synonymous with 'Private Equity', rather than merely a small part of Private Equity funds globally by number (probably no more than about 5% since 2001). This is a mistake of huge proportions since, as we will see, Buyout funds, and in particular those very large ones which have come to be described as the mega funds, are so completely different from, say, early-stage Venture Capital funds in just about every respect as almost to constitute a different asset class altogether. In fact, there are those who suggest that the gulf between them is so wide that perhaps there is no such thing as 'Private Equity as an asset class' at all.

We see the obvious result of such muddled use of language in the current attempts by legislators worldwide to bind Private Equity funds tightly in a straightjacket of new regulation. Even if this were a valid response to the problems currently being experienced by (and, some legislators argue, caused by) the mega Buyout funds (which is highly questionable), it would still be a response to the wrong problem, since they would actually be regulating something very different from their intended target.

We also see it in the reaction by many investors when Private Equity is mentioned of 'don't you mean illiquid, leveraged equity?'. Quite apart from the ignorance (most of the world's Private Equity transactions are entirely unleveraged) and prejudice embodied in such a remark, this leads to dangerous practices and misleading advice.

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[1] See, for example, Ayer, A.J. (2001) *Language, Truth and Logic*, Penguin, London.

Dangerous practices in that many investors either decide not to make an allocation to Private Equity based upon such mistaken beliefs, or believe that they can achieve the same result by taking a leveraged position in a quoted equity index.

Misleading advice in that many large consultancy firms are telling their pension fund clients that in terms both of its likely returns and its 'risk' (though what they are really referring to is the volatility of historic returns), Private Equity can be safely considered to behave in exactly the same way as quoted equities, but with everything increased by a given multiple (usually about 1.6). Worse even than this, when the real life figures stubbornly refuse to support this assumption, then those figures are assumed to be wrong and notional ones substituted which are reassuringly in line with the originally suggested approach. It may seem absurd that supposedly reputable and professional consultancy firms should be using their assumptions to create data rather than vice versa, but that is exactly what is happening in many cases.

Equally dangerously, this misuse of language has led many investors to believe that they need only invest in the mega funds, and that the rest of the industry (about 95% of funds worldwide) can safely be ignored. There are various investors, for example, whose initial screening process is to filter out all those funds which are less than US$1 billion, and which are not managed by a select short list comprising the big names that regularly make it into the media. The fact that this results in a dramatically undiversified portfolio is masked in many cases by the underlying assumption that 'Private Equity' and 'mega Buyout' are, in fact, one and the same, when they are not: the latter is simply one component of the former.

Further confusion has arisen over the difference between Private Equity funds and Hedge funds, with many investors assuming that they are simply the same animal in different clothing. Some investors simply refer to them all dismissively as 'vulture funds', which is actually an insult to both, since very few of either category prey on failing companies. For this reason a whole new section has been included in the next chapter setting out the different structures, objectives and workings of both Hedge funds and Private Equity funds. As will be seen, there are fundamental differences in each of these areas.

The need for a precise definition having been demonstrated, let us move on to ask the vital question 'what is Private Equity?'. However, here, too, there is a need for discussion, since the traditional classifications are coming to be seen as unduly restrictive.

WHAT IS PRIVATE EQUITY?

It used to be quite easy to define what was and was not Private Equity investment: 'any equity investment in a company which is not quoted on a stock exchange'. This statement still holds true for the overwhelming majority of the world's Private Equity transactions. If you are looking for one definition of universal truth, however, this rather simplistic description has been in trouble for a long time. What about investments which are structured as convertible debt? What about companies which are publicly listed but are taken private? Or where the company remains listed but the particular instrument into which the new investment occurs is not?

Clearly the question 'what is Private Equity?' is no longer capable of being answered quickly and simply, even if it ever was. Without wishing to confuse the reader still further, there was, in the period up to about the middle of 2007, an increasing convergence between the activities of Private Equity funds, Hedge funds and Property (real estate) funds. However, there was a well-known law case in England many years ago when a judge famously said that although you cannot define an elephant you still recognise one when you see it (though some believe he may have pinched this idea from Doctor Johnson without acknowledgement). Hopefully, after reading this book everyone will have an instinct for what a Private Equity transaction is or is not, but it is growing increasingly difficult to be certain about this as the parameters of the asset class are being stretched all the time.

In the rest of this chapter I am going to set out some sub-divisions within the overall Private Equity asset class, many of which will then be developed in more detail in the following chapters. However, it will be necessary first to look at the different levels at which Private Equity investment operates.

Fund Investing versus Direct Investing

There is a fundamental distinction in the Private Equity world between those who invest in funds and those who then manage the capital invested in those funds by making investments into companies. This distinction is sometimes defined by the terms ‘fund investing’ and ‘direct investing’, and people will be heard referring to ‘investing at the fund level’ or ‘at the direct level’ or ‘at the company level’ (the last two being different ways of expressing the same thing).

We also have to deal with what Oscar Wilde described as ‘a single people divided by a common language’, although, to be fair, US Private Equity terminology has become increasingly common in Europe and I shall usually be adopting it as industry standard, except where it is absolutely essential to draw some particular distinction of meaning.

In America, those who invest in funds are called ‘LPs’, since the most common form of Private Equity fund is a Limited Partnership, the passive investors in which are called Limited Partners. In Europe, such folk have historically been called simply ‘investors’. There are various different types of LP and it is worth spending some time examining these here, since they will all have different investment criteria and, most importantly of all, different levels of knowledge of the asset class (with higher levels of knowledge being typically referred to rather arrogantly as ‘sophistication’).

At the top end of the scale are the Fund of Funds managers. These usually do nothing except invest in Private Equity (though some have branched out into other areas such as real estate), and the best of them will have staff with perhaps twenty years’ specialist experience. Some (Horsley Bridge would be a good example) might specialise in one particular area (traditionally early-stage US Venture in their case) whereas others (Harborvest, to give an example of similar vintage) are generalist both as to the type of investments which they make and the geographical areas which they cover. As far as geography is concerned, however, the bulk of Private Equity activity to date has occurred in the US and in Europe and it is these two areas into which the Private Equity world has traditionally been sub-divided. While this will undoubtedly change (some investors are targeting Asian funds for 30% or more of their portfolio), the transition is being hampered by reluctance on the part of GPs in areas such as Asia and South America to lodge their fund data with the industry’s data providers, an essential prerequisite to investment for many LPs.

For most investors seeking to enter the asset class, the Fund of Funds approach will be preferred. Few will have the relevant levels of specialist expertise available in-house to be able consistently to select the best partnerships and, even if one could, many of the best are ‘invitation only’ so that gaining access to them may well prove impossible anyway; this is a particular issue with US Venture funds. Outside the US there is a further issue which is that allocations to Private Equity are usually unrealistically low (so low, in fact, that most investors would do better not to be making any allocation at all) so that not only can the cost of acquiring such expertise never be contemplated, but there is no way in which even unskilled time can be made available to study and analyse the several hundred fund offerings which are likely to be received in any one year.

The Fund of Funds approach provides skilled fund selection expertise. It also ensures that capital will be committed on a scientific basis every year (very important to obtain diversification by time, as we will see), and that all reporting and accounting at the partnership level will be taken care of. In fact, the Fund of Funds route into the asset class can be thought of as the 'fire and forget' option. Provided one commits to each successive Fund of Funds vehicle from that manager (typically every three years), then one can simply sit back and manage the cash inflows and outflows.

The next step up might be to use some aspects of the Fund of Funds approach but perhaps supplemented by one's own efforts. For example, a European investor who has taken the trouble to set a proper allocation level and to acquire relevant internal expertise, may feel confident enough to start making, say, European Buyout selections but may wish to use specialist Fund of Fund products aimed at, for example, US Buyout and Venture. Alternatively, such specialist funds can be used simply to add a 'tilt' to a Private Equity programme by going underweight or overweight in a particular area.

Direct investment is the final layer in the Private Equity environment, where money actually gets channelled into investee companies, and this is the role of the Private Equity manager ('GP'), although sometimes making use of co-investment by LPs. The investment process may therefore be seen as consisting broadly of three levels: the Fund of Funds level, the fund level and the company level, and it is the distinction between the last two of these which we label the difference between 'fund investment' and 'direct investment'.

Each requires its own particular modelling and analysis, and we will be looking at this in more detail in later chapters. Importantly, each also requires its own skills. This is often overlooked by investors who, not content with fund investing, decide they would also like to share in some of the 'fun' of direct investing. As we will see in a moment, where this takes the form of co-investment alongside a fund, it will usually have an adverse impact on diversification. Where it takes place directly, without even the comforting umbrella of a fund co-investor, then it is frequently a recipe for disaster since few investors have the skills of a specialist GP. This was a particular problem during the dot com bubble, as various family offices, banks and large corporates scrambled to take stakes in technology and Internet companies without the relevant company-building skills to ensure their success, and also without the discipline and mental toughness to ride out the bad times when they inevitably arrived. Many of these companies would have been doomed in any event, with hopelessly ill-conceived business plans and poor management, but not all. Who knows how many struggling but worthwhile companies might have survived the post-bubble maelstrom if the business of direct investing had been left to the professionals?

Co-investment

It may seem perverse that many Fund of Funds and other investors should also make direct investments alongside their fund investments (this is known as 'co-investment' because it usually takes the form of persuading the manager of a fund into which you have put money to allow you to invest alongside the fund in one or more of its portfolio companies). I say 'perverse' because there is an obvious argument that by indulging in co-investment one actually harms exactly that diversification which is one of the advantages usually cited by Fund of Funds managers of investing in their programmes. They would argue, on the contrary, that the amounts involved are relatively small, that the overall impact of management fees is lessened, albeit very slightly, and that it enables investors to put more money to work in the asset class than would otherwise be the case.

There has, however, been an interesting development here in recent years. Let us first see what it is, and then understand the reasons behind it.

The development has been the introduction of dedicated co-investment vehicles by Fund of Funds managers. Previously (though these are still sometimes encountered), where these were found they took the form of a pool of additional capital being managed by the GP of a Private Equity fund alongside the fund itself. In some cases this was because the GP had transitioned from being the manager of a quoted vehicle, such as an investment trust in the UK (Candover would be one example), and decided to keep that pool of money alive so that investments made by the GP would be drawn partly from the quoted vehicle and partly from the fund.

These were an accident of history, however, rather than a deliberately introduced measure. In the latter such case, a GP would offer certain LPs (usually the biggest few within the fund) the option of also committing capital to a special co-investment vehicle, which would participate alongside the fund in its larger deals. The co-investment pool would typically have a lower cost to the LP than the main fund, sometimes very much lower indeed.

What is important to understand here, and highly significant in terms of its implications for the Private Equity industry, is that the motivation behind co-investment vehicles has changed dramatically. The traditional form of co-investment pool was attractive to manager (GP) and investor (LP) alike. For the GP, it gave them the opportunity to target much bigger companies than would otherwise have been the case given the size of their fund. This would often be described as 'punching above our weight'. What became clear in the early years of the Buyout industry was that the internal processes of investors who asked for the opportunity to co-invest alongside the fund were often incapable of producing decisions within the required time frame. A distinct pool managed by the GP, on the other hand, was subject to exactly the same decision process as the fund itself, and the GP could thus safely enter into a purchase contract without having to worry about whether a piece of their intended equity finance might fall away at the last minute. The advantage conferred by such certainty was worth paying for, in the shape of lower charges to the LP on that additional capital.

For the LP, the main motivation was usually being able to put more capital to work than might otherwise be the case. Until the explosion in average fund size from about 2003 onwards, it was frequently the case that investors were simply unable to secure as large a commitment to a particular fund as they would like, and thus the co-investment pool was a welcome, though uncertain, addition. This is still the case with the world's largest investors, many of whom have been forced to scale back their percentage allocations to Private Equity because of problems in finding sufficient amounts of quality product.

Nowadays, things are different. The main motivating factor has become the lower cost that such investment carries. Buyout returns have been squeezed in recent years, particularly in Europe when viewed in comparison to the very high returns earned during the 90s, and, as we will see, the cost to the LP of investing in a particular pool has become a major factor when calculating their net return.

Terminology

I have referred to the Oscar Wilde factor above and while I propose to deal with this largely by ignoring it, there are some important points to make right at the outset, since there are some differences in terminology which go to the very heart of understanding the asset class, and which are a constant source of confusion for the uninitiated.

In Europe, the asset class as a whole is called ‘Private Equity’, and has traditionally been broadly sub-divided into ‘Buyout’ and ‘Venture Capital’ (or just ‘Venture’), as we will see below. While this broad classification has also held good in the US, different terms have frequently been used. There, the asset class as a whole has sometimes been called ‘Venture Capital’, and Buyouts (particularly large ones) have usually been referred to as ‘Private Equity’. I think you will see at once the huge scope for confusion which this creates. I am frequently consulted by journalists working for national newspapers who are about to write an article on the sector, and find myself having to make this point again and again; it seems that I have been only partially successful, since I have lost count of the number of times I have seen large European Buyout firms referred to as ‘Venture Capitalists’.

In fairness to the journalists involved, none of whom pretend to be experts on the sector, this confusion is, to a certain extent, perpetuated and encouraged within Europe for the rather cynical purposes of those concerned. In the right hands, Venture Capital is a powerful tool for economic growth. Research suggests that already by the end of 2000, Venture Capital had directly created about 8 million new jobs in the US (roughly equivalent to one job for every \$36 000 of investment), and that if one added into the mix the jobs created indirectly in supporting and related businesses, then the total rose to a staggering 27 million.[2] No comparable studies have been made in Europe; the deliberate confusion between Venture and Buyout makes any reference to ‘Venture-backed’ companies meaningless in this context. However, it is logically impossible that Venture has had no effect whatever. It must therefore be accepted that Venture Capital is socially and economically desirable, since it has a clear tendency to boost both GDP and employment. Venture Capital typically represents less than 1% of total capital investment in any one year in the US, yet venture-backed companies are said to create about 13% of GDP.[3]

Buyout, by contrast, can be seen by those European governments who practice what might be termed a ‘social economic’ model (most of the continental countries, and increasingly the UK) as undesirable. As we discuss how Buyout operates it will become clear why Buyout transactions are frequently attacked as having the effect of reducing employment through restructuring and rationalisation,[4] and certainly of decreasing tax yield, since financial structuring will use loan interest to reduce taxable earnings. It is for this reason that, unlike in the United States, where there are rigidly separate industry bodies for Venture Capital and ‘Private Equity’ (Buyout), industry bodies in Europe have sought to wrap themselves in the flag of Venture Capital.

It used to be the case that wherever you saw the word ‘Democratic’ as part of the name of a country, then you could be absolutely sure that, far from being ‘democratic’ the country

[2] Public Sector Review: Finance, Summer 2004 pp 62–63.

[3] Public Sector Review, as before.

[4] Though this is hotly disputed by the Private Equity industry. Indeed, these objections were largely abandoned during the Parliamentary Committee proceedings in the UK in 2008 when figures were released by the Centre for Management Buyout Research at the University of Nottingham which strongly suggested that across the whole period of Private Equity ownership (as opposed to the first few months), average headcount actually increased.

would, on the contrary, be a totalitarian police state (the former East Germany would be a prime example). So it is with the word ‘Venture’ in Europe. The British Venture Capital Association, for example, speaks (despite its name), not, as one might expect, for the Venture community in the UK but overwhelmingly by member fund size for the Buyout community transacting deals across Europe. The European Venture Capital Association suffers from a similar identity crisis.

This is unfortunate for all sorts of reasons, not least that the Venture community in Europe is left without any representative body of its own. Fortunately for the BVCA and the European Buyout community, European politicians are sufficiently, er, unsophisticated that this deception goes unmasked. Unfortunately for the European Venture community, they are forced unjustly to endure the brickbats which are regularly aimed at ‘Venture Capitalists’ (meaning Buyout firms) by left-wing politicians, which may, in the future, include draconian regulation.

It will be apparent from the title of this book that I have chosen to adopt ‘Private Equity’ as the name of the asset class as a whole, and ‘Buyout’ and ‘Venture’ as its two main constituents. I believe that this is the least confusing approach available and it reflects the way in which I have always viewed the asset class. I will generally be adopting the US expressions ‘LP’ (Limited Partner) and ‘GP’ (General Partner) for ‘investor’ and ‘firm’ or ‘manager’ respectively, but there will be occasions when the context suggests that the European terms should be preferred. Incidentally, it may come as a surprise for American readers to learn that the terms ‘LP’ and ‘GP’ were entirely unknown in the European Private Equity industry until about ten years ago.

However, while investors and data providers alike cling to this traditional binary classification of funds into ‘Buyout’ and ‘Venture’, it is inadequate to describe the various types of Private Equity activity that actually take place. In particular, both Growth Capital and Development Capital are distinct types of investment that currently have to be shoe-horned into one of these categories. In consequence, while we will examine later in this chapter the traditional division of Private Equity into ‘Venture’ and ‘Buyout’, Growth and Development Capital can no longer be ignored, not least since they are dominant forms of Private Equity investment in the new, but rapidly growing, markets of Asia, Eastern Europe and South America. Thus, the reader will find both an outline description of them in this chapter and also a whole new chapter describing Growth and Development Capital, which may conveniently be studied together since they are similar in appearance.

Having done that, we will be in a position to set out in summary form all the different kinds of Private Equity investment which occur both at the company and the fund level, but in case you would like to glance ahead, please see Table 1.2 on page 13.

Different Types of Private Equity Investment

There are four main types of what might be termed ‘pure’ Private Equity investment at the company level: Buyout, Development (Capital), Growth (Capital) and Venture (Capital). It is almost certainly simplest to think of these in terms of the type of company in which they invest, and here it is useful to refer to the Product Life Cycle, see Figure 1.1 (though this can equally well apply to a new service as to a new product).

Many will already be familiar with this basic tool of business analysis, which is widely used by marketing strategists. However, it may also be thought of as very conveniently delineating the ‘hunting ground’ of each of the four main types of Private Equity activity.

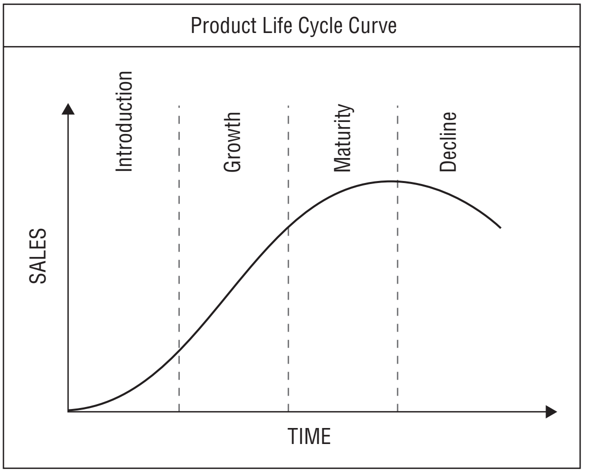

Figure 1.1 Private Equity type by PLC stage

The key thing to bear in mind (and indeed the main driver behind the development of the PLC in the first place) is that a company's cash flow should become steadily stronger as it moves to the right in time along the PLC (as we will see when we look at Growth Capital, things are slightly more complex than this, but this is the basic principle).

In other words, when a company is in the 'Introduction' stage it will initially have no cash inflows at all, since it will still be developing its offering and will thus have nothing to sell. By the time it moves into the 'Growth' stage, it will be generating some income but, given the very substantial cost of promoting its offering in a growing market, overall cash flow is likely still to be strongly negative. Once the 'Mature' stage arrives, then the company should be both profitable and have positive cash flow. However, the strongest cash flows are usually to be found in the 'Decline' stage of the PLC. This may seem counter-intuitive; how can a market be attractive where demand is falling? The answer (or at least the theory) is that by this time the least successful competitors will have exited the market ('market consolidation') and relatively little money will need to be spent on development and promotion.

At the same time, as a company moves to the right along the PLC its risk of not surviving will decrease steadily. For those who work in the Private Equity industry this is really just two different ways of stating the same thing, since until cash flow break-even is reached, the Private Equity investor faces a continuing decision as to whether or not to continue to inject fresh capital into the business, whereas once cash flow turns positive, the business can theoretically at least survive without the need for further outside support. These two closely related trends should be borne in mind as we look at each type of Private Equity in turn.

Venture Capital targets the Introduction stage of the PLC. Thus, Venture-backed companies will be at a very young stage of their life, and perhaps even total start-ups which have been conceived but not yet born. The question of whether or not it will survive until adulthood will be a constant issue hanging over each one, as there is a very high rate of infant mortality.

Growth Capital targets, unsurprisingly, the Growth stage of the PLC. Growth companies are characterised by the need to ramp up their sales very quickly so as to be able at least to hold steady their percentage share of a rapidly growing market, and, as with Venture companies, cash flow will therefore almost always be negative because of the costs of promotion and business development.

Both *Buyout* and *Development Capital* target the Mature and Decline stages of the PLC. Later, we will examine more fully the difference between them, but in this case it has to do not with the type of company being targeted but with the way(s) in which the investment is carried out. Buyout will involve the taking of a majority stake, whereas Development funds take a minority stake. This is often referred to as 'control' and 'non-control' investing respectively, although we will see that this is a rather simplistic view. Partly because of this, Buyout investments will always be leveraged by the use of acquisition debt and related finance, whereas Development deals will not.

A broad delineation: Buyout and Venture

There is, however, a practical problem here which we will encounter in different guises as we explore the Private Equity industry, which is that its members and data providers do not always divide things as neatly as we would wish, or in the same way. We stub our toe straight away here, as the data providers do not recognise the same compartments that we wish to study. There are, for example, no industry figures which break out returns for Growth or Development, these being lumped into either Buyout or Venture, and not always on a consistent basis. In the past, it was felt by many that this did little harm. While there are very many Growth and Development deals done every year, these are typically relatively small in size individually and definitely very small in total value compared to either Buyout or Venture. This effect is compounded by the reluctance of many of those firms who make such investments to register their data, thus rendering Growth and Development statistically even more insignificant. In this case, the argument runs, if one is looking to research the performance of the industry as a whole from the available figures, then little harm is done in practice by the traditional approach.

It is difficult to refute this view, unless one is a statistician of a purist nature. However, it will almost certainly become easier, and indeed more necessary, to do so with each passing year. One of the clear trends in Private Equity activity in recent years has been an increasing amount of money being raised for investment in newly emerging geographic markets, and here, for various reasons which we will explore, Growth and Development predominate. As more and more of these players begin to make their fund data available, it will become vital to be able to differentiate between the performance of, say, Development and Buyout deals, and unless the present system is reformed, then the relevant data will simply not be available to allow this to be done.

It should also be understood that many firms in continental Europe have, for many years, traditionally pursued both Buyout and Development Capital deals within the same fund, usually confusingly referred to as a 'Buyout' fund. So, unless data were available at the level of the individual company, and could be extracted and evaluated separately, then fund returns still might not be very meaningful. These points will be better understood after we have examined the way in which Private Equity returns are measured.

It is also undeniable that the vast majority of the world's Private Equity fund investors (LPs) refer simply to 'Buyout' and 'Venture' when discussing their Private Equity allocations and investments. It is almost unknown (though logically this should change) for them to have any specific allocation to 'Growth' or 'Development'. The data providers might therefore argue, with every justification, that the way they divide up Private Equity returns simply reflects the way in which their clients view the world.

For all these reasons, it was decided that Growth and Development Capital did not merit their own chapter in the first edition of this book, though even then this was a marginal decision. Partly, it was felt that introducing yet another source of complexity into an asset class which is already very difficult to understand might serve simply to confuse people unnecessarily. Given the continued expansion of these sectors since 2006, though, this is no longer a tenable approach and so the reader will find a new chapter dealing specifically with such investment.

Now that we know that is coming, however, let us, for the moment, explore the traditional classification of the Private Equity world into Buyout and Venture. We have already seen that their respective investment focus is to be found at different ends of the PLC, but what does this mean in practical terms?

Buyout can be distinguished from Venture Capital in a number of ways. Chief among these are the fact that it generally focuses on established companies rather than young businesses. It is also generally true that it tends to concern itself with 'traditional' business activities rather than technology, although this distinction is becoming somewhat blurred as former 'dot com' and technology businesses mature. We have already seen a number of Buyouts in the Telecoms space (some of them very large) and there is no logical reason why a company which has originally been Venture-backed should not, in the full course of time, be the subject of a Buyout transaction. It is, however, fair to say that, while the businesses of Buyout companies may be increasingly technology-related, they will never carry any pure technology risk.

Size is also often advanced as a differentiating factor, and now that the excessive valuations of the dot com bubble have subsided, this can also probably be adopted with some confidence as a general truth. However, this, too, should be treated with some caution. While it is certainly true that the average size of Buyout funds is getting larger and larger, enabling them, in turn, to transact larger and larger deals, there are still a few Buyout firms who are happy to operate at the smaller end of the market, while some Venture funds are well in excess of $1 billion.

Another important distinction is that between 'control' and 'non-control' investing, the former being where the Private Equity manager either owns a majority of the shares in the company or at least has control over the majority of the voting rights. It is extremely unusual to find a Venture Capitalist having control over a company, except where this may have occurred through the failure of the company to achieve its targets and the triggering of default and/or preference rights.

A further important distinction, and one of some political sensitivity, lies in the use of leverage. Buyout transactions are structured using both equity (provided by the fund) and debt[5] (from external providers), whereas Venture transactions use only equity. There are two main reasons for this. First, for financial engineering purposes, a major controlling shareholding is required in order to structure a debt package in a tax-effective manner. Second, in order to service the debt, the company must be producing cash flow and usually also earnings, though the two are not, of course, the same thing. Venture Capital investments do not satisfy either of these requirements.

[5]This description is deliberately simplistic. In reality there may be both debt and mezzanine, and often several layers of each.

Table 1.1 Traditional guidelines for classifying private equity transactions

Venture	Buyout
Small enterprise value (particularly in Europe)	Large enterprise value, sometimes very large (multi-billion)
Bank debt almost never used	Bank debt almost always used
Young companies, even start-up	Generally mature, established companies
Investee companies rarely profit-making	Profit levels of investee companies crucial (although turnaround situations are considered)
Investee company will always be developing or applying new technology	Technology considerations largely irrelevant
A minority stake will always be taken. Control will usually only arise through default and/or refinancing	Control always present in true Buyouts, though some firms practise Development Capital
Valuation largely a matter of instinct and experience	Firm rules of financial theory available with which to calculate valuation (e.g. earnings multiple)
Venture managers will often have been successful start-up entrepreneurs and/or will have specialist technology expertise	Buyout managers typically come from an accountancy, investment banking or management consultancy background

These factors are advanced as suggested guidelines and while they will prove helpful, and perhaps even definitive in most cases, I think it will be obvious even from the brief outline above that there will always be some that defy precise definition. How would you classify, for example, a firm that took majority stakes in fairly mature technology companies using only equity, or a firm that used debt financing to take a majority stake in a troubled early-stage company? Happily, common sense will usually prevail but Table 1.1, which may be thought of as a sort of Private Equity litmus test, may prove helpful.

Secondary fund investing

When the first edition of this book was being written and discussed in 2006, it seemed as though secondary transactions did not represent a sufficiently large part of the industry as a whole to warrant a separate chapter. Again, this was a borderline decision (I did actually draft a chapter, but finally decided not to use it) but it has become even more obvious since then that secondary investing has become a very significant part of the Private Equity landscape, and also has an important part to play in the planning of Private Equity fund programmes, particularly in the early stages. We will examine both these areas in more detail later, but for the moment I am happy to advance a preliminary explanation of what secondary transactions are and how they work.

It is widely assumed by investors that Private Equity funds are illiquid investments. While this is strictly true as a matter of law (in the sense that they are not quoted on an exchange), it is not true as a matter of practice, because of the very active secondary market which exists. Briefly, if you hold an interest in a Private Equity fund and wish, for whatever reason, to sell it (thus also bringing to an end your obligation to continue to fund capital calls), then there are a significant number of specialist secondary purchasers who will be happy to quote you a price for it. Various investors and Funds of Funds also play in this space, though it does not form the main thrust of their activities.

Secondary transactions also take place at the company level, typically taking the form of a GP seeking to sell the remaining portfolio of a fund in order to be able to wind it up in