

Understanding Private Equity and Venture Capital

- What is private equity?
 - Private equity is finance provided in exchange for an equity stake in a company. Private equity is provided on a medium to long term basis and provides a capital base for future growth. Investors can provide strategic operational and financial advice based on experience with other companies in similar situations.
- What is venture capital?
 - The term Venture Capital refers particularly to the private equity investments made at the very early stage of a business in order for the business to grow and develop. The terms Private Equity and Venture Capital are often used interchangeably.
- Who provides private equity?
 - Private equity is provided by private equity firms and by business angels.
- Can private equity help my business?
 - If you are aiming to start up, expand, turnaround, buy into or buy out a business, private equity funding could help you. Private equity investors are seeking unlisted businesses with potential for growth who are willing to trade a share in the company for investment. Private equity funding is provided to businesses in all sectors including food, technology, retail and manufacturing.
- How does private equity work?
 - Private equity investors receive an agreed share of the company in return for the risk of investing. The investor is a business partner, sharing the risks and successes of the company. Funding through private equity is very different than receiving a bank loan. Repayments for bank loans must be made according to a contract, regardless of the success or failure of your business. Private equity investors hold a stake in your company and their return on their investment is dependent upon your business growth. Many private equity investors provide management expertise and experience, contacts and discipline. The investor has to be very careful about their investment because of the high risk in a company failing. They therefore have to check that the information provided is correct (due diligence) and they seek returns that are very high. In general, private equity investors are interested in companies which have the potential to significantly increase turnover within 2-5 years.
- Do I need a private equity partner?
 - For private businesses, finding the money required to achieve significant growth can be the biggest factor prohibiting expansion. If you are willing to trade a share of your business to an experienced private equity investor, you stand to benefit from not only the injection of money but also the experience and skills of your new partner. Private equity investors aim to increase the profitability of their investment companies by providing a stable base for strategic decision making, not by taking day to day control. Think of it this way: you may have a smaller percentage ownership, however in a few years, that percentage should be worth more than the whole of your business was before. However, if you are not willing to release a share in your business, private equity investment is not suitable for you.
- What is a private equity firm?
 - Private equity firms are fund managers who invest capital on behalf of institutional clients such as superannuation funds and insurance companies. They are exposed to the risk of the company failing and as a result, look to invest in companies which have the ability to grow very successfully and give higher than average returns to compensate for the risk. When private equity firms invest in a business they become part owners and generally require a seat on the company's board of directors. They usually do not take day to day control.
- Where do Private Equity Firms get their funds?
 - Most private equity firms raise their funds from institutional investors such as pension funds, insurance companies, endowments, foundations and high net worth individuals.

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- What is a Business Angel?
 - "Angel" investors tend to be wealthy individuals who may look to invest in a high-growth company that has synergy with their own business or competes in a market where they have succeeded. "Angel" investors generally invest in small businesses in deals considered too small for private equity firms. Typical "angel" investments are around \$10,000 to \$1 million. As "angel" investors generally invest in companies within their own expertise, the investor may seek a hands-on role in the management of the company or will look to act as the company's mentor.
- What is the difference between Private Equity Firms and Angel Investors?
 - Private equity firms are professional investors who dedicate all of their time to investing and building innovative companies. The angel investor is an individual who invests in companies for their own interest. Typically angel investors invest less than \$1 million in any particular company, whereas private equity firms usually invest more than \$1million per company. Angel investors are usually successful business people who have spare cash that they see achieving comparatively little in their bank accounts. The value of angel investors is that they often back and finance small businesses. Angel investors expect a return on their money of at least 30% and want equity as a security for risk. Angel investors generally invest in companies within their own expertise; the investor may seek a hands-on role in the management of the company or will look to act as the company's mentor.
- What do investors look for in a company?
 - In order to gain private equity investment a company must be able to demonstrate:
 - A product or service with a unique selling point
 - A business plan showing growth prospects and the ambition of the company
 - An effective management team with relevant experience
 - Efficient financial management
 - A planned strategy for offering a share in the company in return for investment
- What rate of return do Private Equity Firms expect?
 - Private equity firms tend to favour high growth companies that are likely to provide them with a high rate of return. The rate of return sought will vary with the risk: seed and start-up deals are considered very high risk and the minimum rates of return sought over the life of the investment will generally be around 30-40 percent per annum and above. As the perceived risk diminishes with the early expansion stage, expansion stage and management buyout and buy in deals, the minimum annualised rates of return may reduce to the 20-30 percent range. Investors generally look to exit the investment after three to seven years.

The private equity firm only realises a return on their investment if the company goes public (IPO) or is merged or purchased by another company. In some cases the investment will be sold to another private equity firm.

- How does the investor realise their return?
 - The investor will want an eventual exit, there are a few ways they can exit the business and it is important to have an exit strategy agreed as early as possible. Ways for an investor to leave a company and realise the return on their investment include:
 - 1) Sell the shares back to you for a profit
 - 2) Sells shares to another investor
 - 3) Sell when the whole company is bought by a larger company
 - 4) Help list the company on the stock exchange

Types of Equity Capital

Investors refer to the type of equity capital by the term that describes the stages of growth that they are funding.

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- Pre-seed / R&D
 - Refers to funds used to expand the concept and advance product development, usually during the research and development phase of the business.
- Seed
 - Provided to companies which have not yet fully established commercial operations, and may also involve continued research and product development.
- Start-up
 - The company is in the process of being set up or may have been in business for a short time. Such firms have not yet sold their product commercially and have no track record. Investee companies have completed the product development stage and require funds to initiate commercial manufacturing and sales.
- Expansion
 - The company is now established and requires capital for further growth and expansion. The company may or may not have made a profit at this stage. This may be a period of rapid growth and the company will usually require several rounds of capital injection as it achieves the milestones set in the business plan.
- Management Buy-out (MBO)
 - These are funds provided to enable current operating management and investors to acquire an existing product or business from a public or private company.
- Management Buy-in (MBI)
 - These are funds provided to enable a manager or group of managers from outside the company to buy in to the company.
- Pre-listing (or pre-IPO)
 - Investment into a company where it plans to list on the Stock Exchange, usually within a period of a few months to two years.
- IPO (Initial Public Offering)
 - The sale or distribution of company shares to the public for the first time (i.e. listing on the Stock Exchange).

For more detailed information on the "formal" private equity, or venture capital, industry refer to the Australian Venture Capital Association Limited (AVCAL) website.

The Venture Capital Board acknowledges the Australian Venture Capital Association Limited (AVCAL) and the Australian Venture Capital Guide as sources for some of the information used in this section of the website.