

## What Is Private Equity?

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The term "private equity" encompasses a range of techniques used to finance commercial ventures in ways that do not involve the use of publicly tradable assets such as corporate stock or bonds. Typical forms of private equity include venture capital, growth and mezzanine capital, angel investing, and private equity funds. Private equity investors seek to obtain a substantial interest in a company in order to gain control over the firm's management. Their goal is to boost the value of a company, sell off their investment, and walk away with substantially more money than they put in.

### Key Stats

- **Private equity firms in the U.S.:** 1,546 (June 2006).
- **Private equity capital under management:** \$811 billion (June 2006)
- **Value of private equity buyouts:** \$660 billion (2006)
- **Largest private equity deal in 2006:** HCA (Hospital Corporation of America), bought out by KKR, Bain Capital, and Merrill Lynch Global Private Equity, \$33 billion

### Why It Matters Now:

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The amount of money flowing through private equity funds is on the rise. A new high-water mark was reached in 2006, as \$215 billion was raised for private equity investment in the United States, topping the prior record of \$178 billion in 2000. According to Private Equity Council, a consortium of investment firms, there's nearly \$700 billion awaiting investment now; analysts expect to see an increase in corporate buyouts in 2007 as a result. Private equity is gaining popularity because it provides a way for investors to have tight control over a company's strategy, management, and financial decisions—without the quarterly scrutiny, public disclosure requirements, and regulatory oversight faced by publicly traded firms.

### Why It Matters to You

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Private equity investors tend to be either institutions or very wealthy individuals, so the average worker might not directly experience the ways in which private equity is having an impact upon corporate strategy and governance. Nevertheless, private equity can have a significant impact on how your company is run or the way it positions itself to compete in the current business environment.

On the modest end, if you work for a small business that's received private equity funding or a startup backed by venture capital, it's very likely that private equity investors play a significant role in your company's board of directors. On a day-to-day basis, that means you're likely to see higher

expectations for sales targets and new business goals. If senior management can't meet those objectives, expect to see new faces in the office soon.

Among larger companies, private investment is responsible for an increasing chunk of mergers and acquisitions—a process that can be extremely disruptive to employees. In 2006, the biggest M&As were in the real estate and healthcare industries.

If you work for a company financed by private equity, be aware of the investors' timeframe for cashing out. When an investment group decides to sell a business, the investors may demand layoffs or other cutbacks to improve the balance sheet and make the company more attractive to suitors. On the other hand, they might also offer retention bonuses to keep valued employees.

## The Strong Points

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Private equity firms specialize in increasing the value of their holdings by reinvigorating the management of a company. This can mean strengthening leadership, refocusing strategy, reducing cost structures, instituting growth initiatives, or even breaking up the company to sell it in parts. When it works as intended, the result is more efficient use of capital, which in turn fuels the economy and drives innovation.

The recent experience of the Warner Music Group provides a good example of how private equity works. In early 2004, a group of private investors purchased the music label from Time Warner for \$2.6 billion. Operational cuts were made, the company went public in May 2005, and in early 2007 it had a market cap of more than \$3 billion—providing the private equity investors with a healthy return on their investment.

## The Weak Spots

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Critics charge that private equity investors seek to boost the value of a company as quickly possible, with little regard for intangible factors such as company history, culture, or workplace environment. In other words, while private equity is great for investors, it may not be so much fun for the companies they invest in or the people who work for them.

Consider the 2000 buyout of KB Toys by Bain Capital. As part of the financing agreement, KB was required to pay Bain a \$121 million special dividend to guarantee its profits. KB couldn't service the debt and went into Chapter 11 bankruptcy protection in 2004. Creditors including Big Lots and Hasbro sued KB management and Bain, alleging that they seized cash to line their own pockets. Bain claimed the company was struggling because of competition from Wal-Mart. When the lawsuit was settled, KB's creditors received pennies on the dollar to repay outstanding debts.

## How to Talk About It

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Here are some key terms used among private equity investors—and those seeking investment from them:

**Angel investor:** A one-on-one or informal type of private-equity investment. Angel investors are often wealthy friends or relatives, although angel investing networks also exist: *"If we can get \$100,000 from each of five angel investors, we'll probably be able to keep development efforts afloat for about a year."*

**"A" round:** An initial round of funding in which venture capitalists put up money for a company formerly backed by founders or angel investors: *"The company raised \$6 million in 'A' round financing."*

**Dutch auction:** A term applied to an initial public offering (IPO) in which the highest bidder gets the opportunity to buy shares first. If any shares are left, the next highest bidder gets those shares, and so on. Google's IPO was the most famous Dutch auction offering to date.

**Exit strategy:** The name of the game in private equity; the approach a private equity firm uses to convert its ownership share of a company into cold, hard cash: *"The IPO market has been sluggish, so an acquisition by one of the industry's leading players may be our best exit strategy."*

**LBO (leveraged buyout):** When an investor gains majority control of a company through the use of debt (usually in the form of borrowed money or bonds). Can be risky if a firm's cash flow is uneven, as this could hinder the company's ability to service its debt.

**Mezzanine capital:** A form of private financing that carries a higher credit risk because it is exchanged for equity that is not secured by collateral or assets in the event of bankruptcy or default: *"Mezzanine capital might make sense if we need to bridge the funding gap until we launch our IPO."*

**Venture capital:** A private equity fund that specializes in early-stage or startup companies. VC's typically have a higher tolerance for risk than other private equity investors.

## Key Players

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Private equity firms have become a haven for former CEOs and big-name politicians. For example, former U.S. president George H.W. Bush was an advisor to the Carlyle Group from 1998 to 2003, and today Carlyle is chaired by former IBM CEO Louis V. Gerstner, Jr.

### Top Five Private Equity Firms:

Rank	Firm Name	Fund Size (\$ million)	Focus
1	Blackstone Group, L.P.	41362.6	Real estate, consumer/industrial, communications
2	The Carlyle Group	35808.8	Telecom/media, real estate, auto/transportation,

			consumer, energy, technology and business services
3	Goldman, Sachs & Co.	31967.4	Varied
4	Texas Pacific Group	26178	Communications, industrial, technology, health care
5	Warburg Pincus, LLC	23010	Financial, health care, IT, energy, consumer/industrial, communications, and real estate

*As of Sept. 30, 2006; Financial data from Thomson Financial*

**Top Five Venture Capital Firms:**

<b>Rank</b>	<b>Firm Name</b>	<b>Fund Size (\$ million)</b>	<b>Focus</b>
1	Warburg Pincus, LLC	8,470.00	Financial, health care, IT, energy, consumer/industrial, communications, and real estate
2	New Enterprise Associates	7,791.50	IT, medical, life science
3	Oak Investment Partners	7,590.00	IT, health care, retail
4	Technology Crossover Ventures (TCV)	4,615.90	Technology
5	Sequoia Capital	4,018.40	Technology

*As of Sept. 30, 2006; Financial data from Thomson Financial and National Venture Capital Association*

## Further Reading

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- Newsletter: [The Journal of Private Equity](#) (Requires subscription.)
- Newsletter: [PEWeek](#), a Thomson Financial-owned site focused on venture-capital news (Requires subscription.)
- Book: "Angel Investing: Matching Startup Funds with Startup Companies—A Guide for Entrepreneurs, Individual Investors, and Venture Capitalists" by Mark Van Osnabrugge and Robert J. Robinson
- Book: "Barbarians at the Gate: The Fall of RJR Nabisco" by Bryan Burrough and John Helyar
- Book: "Rich Dad's Advisors: How to Attract Other People's Money for Your Investments—The Ultimate Leverage" by Michael A. Lechter
- Blog: [Paul Kedrosky's Infectious Greed](#)
- Blog: [VentureBeat](#)
- Blog: [Going Private; the Sardonic Memoirs of a Private Equity Professional](#)

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