PRIVATE EQUITY INVESTORPROFILE

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Abstract: The new economic reality, the absence of predictability regarding the financing sources poses a challenge for the companies – that of identifying innovative solutions to cover the need of financing. The necessity to compensate the credit volume reduction forced companies to identify innovative financing solutions. Private equity is a financing alternative. But private equity funds do not invest in any kind of company. This study aims to analyze the profile of private equity investors from the first company providing venture capital (American Research and Development Corporation) continuing with borrowed resources takeovers and bringing up to date the latest developments in the field. The study also highlights the changes in the preferences of private equity investor.

Key-words: ***Private equity, venture capital, Buyout; financing option***

Introduction

Firms have the possibility to choose between different financial resources provided by capital markets or banking market, financial system and national economic and financial phenomena generated by large-scale (financial liberalization, financial innovation). However, the national financial system, financial crises but also the legal status of firms, size and internal conditions restricting their access to some funding resources. In these circumstances, the question arises whether private equity can be considered a financing option to offset certain shortcomings of traditional resources. If yes, what would be the target segment of private equity investors. Before answering these questions should be clarified certain theoretical aspects such as: the concept of private equity, funding mechanism by private equity firms, etc.

Private equity as a financing option, are found on these references: private equity investment has grown to be a valuable asset class in capital markets in the past decade (Osborne, Katselas and Chapple, 2012); Caselli (2010) highlights the potential role of private equity and venture capital as the only financial institutions who can support firms during all stages and draws attention to the fact that private equity and venture capital deals cannot be considered " traditional " financial deals for two reasons: the different evaluation system and the above average risk profile. In the same idea, Onofrei & Anton (2010) continue: "private equity can be considered an innovative funding source because, unlike traditional sources of funding, private equity creates a close relationship between the company and private equity firm".

Modern private equity and venture capital have been around since the 1940s when it started to be useful and essential for financial markets and a firm's development (Caselli, 2010). Financing firms by private equity and venture capital has become increasingly more important. In this regard, Metrick and Yasuda (2010) reminded that the worldwide private equity funds manage approximately $1 trillion of capital. According to recent research, through 2012 private equity funds worldwide have distributed more than $1.4 trillion to limited partner investors.

Because this type of business has been around so long, together with differences between firms and financial markets, one worldwide definition and classification for private equity and/or venture capital does not exist.

Institutionally, private equity is the provision of capital and management expertise given to companies to create value and, consequently, generate big capital gains after the deal. Usually, the holding period of these investments is defined as medium or long (Caselli, 2010).

Different approaches are found also in establishing private equity investment components. According to the American version, venture capital is a cluster of private equity dedicated to finance new ventures. Therefore, venture capitalists fund firms during their initial phases or look for sources to expand and develop the activity of the firm, whereas private equity operators fund firms at the end of their first/fast growth process (Caselli, 2010).

The European definition proposes that private equity and venture capital are two separate clusters based on the life cycle of the firm. Venture capitalists provide the funding for start-up businesses and early stage companies, whereas private equity operators are involved in deals with older firms. Different from the American definition, the European definition does not consider the expansion phase (the phase after the beginning and the start-up) as a part of venture capital, but more of an autonomous subcategory (Caselli, 2010).

In literature and statistics provided by associations, studies differently focuses on venture capital component or component Buy Out.

Buyout operations recorded the highest value of transactions due to their high dimensions compared with other investments. In the peak years of the early twenty-first-century cycle, these buyout funds were responsible for about one-quarter of all global merger and acquisition (M&A) activity. Venture capital funds—the other main type of private equity-raised nearly $160 billion of capital during the boom years of 1999 and 2000 (Metrick and Yasuda, 2010).

Private equity cycle

Gompers and Lerner have subdivided the venture capital (and private equity) cycle into standard phases: fundraising, investing, and exit.

Overall, private equity funds play an increasingly important role as financial intermediaries in addition to their significant day-to-day involvement as board members and advisers. For young firms or a new business idea, cooperation with financiers is very important, because reputation, know-how, networking, relationships, competencies, and skills are the non-financial resources provided by private equity and venture capital operators. Private equity financiers support firms with their skills, competencies, know-how, etc. Because this creates value for funded firms, the investor allows the entrepreneur to take value from the funded idea. In most cases, without private equity or venture capitalists, firms would not be able to develop projects.

Even though funding institutions are active shareholders and engaged in company management, they are not interested in taking total control or transforming their temporary participation into long-term involvement. Venture capitalists and private equity operators, sooner or later, sell their position because, as mentioned Caselli (2010), this is the most important reason for defining this type of investment as “ financial ” and not “ industrial. ”

The presence of a predefined time horizon for the investment makes private equity and venture capital useful for firms wanting quick development, managerial change, financial stability, etc.

The private equity cycle involves at least three different types of participants: suppliers of financial sources, private equity operators, and beneficiaries of financial sources.

The first group supplies funds to financial institutions because they are not skilled enough to analyze deals or they cannot bear the risk. Public and private pension funds, endowments and foundations are the largest investors in private equity funds. On a dollar-weighted basis, U.S. public pension funds invest 9.4% of their portfolio in private equity. Private equity delivers superior returns to its investors. A review of 150 public pension funds across the U.S. found that private equity delivered a 12.3 percent median 10-year annualized return to pension funds, outperforming the returns of other asset classes (fixed income, listed equity and real estate). These results were provided by a study conducted by the Private Equity Growth Capital Council uses data collected by Bison to examine the private equity investments of over 150 U.S. public pension funds. The information was collected either through direct communication with pension funds or from publicly available comprehensive annual financial reports. In Europe, pension funds provided almost 40% of sources of funds. Fund of funds contributed 16%, followed by sovereign wealth funds (11%) and insurance companies (11%). Around half of the amount (€26.2bn) was raised from institutional investors outside Europe (EVCA, 2013).

The second group is made up of financial institutions whose tasks are to define, select, control, and monitor investments.

Finally, beneficiaries are companies that receive financial sources, implement expansion projects or turn-around or change of ownership, and accept all conditions and clauses provided by financial institutions.

Private equity investor preferences

Private equity investor preferences are determined by macroeconomic factors, the characteristics and the location businesses, sector in which the firms operate.

Groh, Liechtenstein and Lieser (2010) identified six main criteria that ultimately determine the attractiveness of an individual country for VC/PE investments: Economic Activity, Depth of Capital Market, Taxation, Investor Protection and Corporate Governance, Human and Social Environment, and Entrepreneurial Culture. Groh, et al (2010) study shows that “The top performers are the United Kingdom, Ireland, Denmark, Sweden and Norway. Germany, the largest European economy, ranks slightly above the average, while other large economies, like as France, Italy, and Spain have rather disappointing scores. Bulgaria, Greece, Slovakia, and are the least attractive European countries for VC and PE investors”. Some countries attract investors with low corporate taxes. The Nordic countries are especially strong in Entrepreneurial Culture. The United Kingdom clearly dominates all the other countries regarding the Investor Protection and Corporate Governance, and Depth of Capital Markets. While their taxation score is below the European average, and the other criteria are on a par. Whether the strength of the investor protection provided in a market is a priority to sophisticated investors such as private equity investors is a useful distinction to make when investigating investor preferences. In contrast, Osborne, Katselas and Chapple (2012) showed that firm-specific characteristics are more influential in target selection than external or institutional variables. They investigated the characteristics and attributes that private equity investors prefer when selecting target acquisitions. In particular, these include firm-specific characteristics such as financial and performance measures, as well as external or institutional determinants, such as jurisdiction. Theirs paper offers evidence that preconceived notions about private equity investment funds targeting underperforming firms are inaccurate, with stock volatility greater for tender/merger offer firms relative to private equity target firms that exhibit higher abnormal operating income and lower stock volatility pre-bid.

As private equity funds are sophisticated investors, French and Poterba (1991), showed that UK, Japanese and US investors heavily overweight their portfolios in their home market. Equity home bias is expected as private equity investors prefer a closer proximity to the target firm for ease of restructuring and corporate control. Agency costs and information asymmetries systematically give rise to differences in the frequency of inter- versus intra-provincial investments, and compare the importance of agency versus institutional factors leading to home bias (Cumming and Atiqah binti Johan, 2006, on a sample of Canadian private equity investors).

Private equity investment involves the acquisition of long-term growth potential target firms, with the aim of restructuring the firm to improve its value. The restructure involves both an injection of finance and stewardship (Black and Gilson, 1998). At the end of its investment horizon, the private equity investor aims to divest the firm at a higher value, concurrently generating wealth for the investors and employees of the restructured target firm. This makes private equity investment potentially advantageous not only for investors but also for the target firm, as it introduces skilled management to identify potential risks and enhance the efficiency and profitability of the acquired firm.

On the other hand, venture capital funds back entrepreneurs with innovative ideas for a product or service who need investment and expert help in growing their companies (EVCA). A 2008 study found that PE-owned companies pursued more economically important innovations than non-PE owned companies, as measured by patent citations, the most commonly used and accepted measure of the economic impact of innovation. Private equity ownership spurs greater advances in innovation.

Private equity investment makes companies stronger when they enter public equity markets. According to a 2006 study, the share price of companies owned by PE firms for a year or more that went public between 1980 and 2002 outperformed the stock market as a whole over a three-to-five year period. A study conducted by Ernst & Young on 2010 private equity-backed IPOs found that the average sponsored IPO increased 27.2% from its offer price by the end of 2010. Private equity has grown into a valuable asset class in capital markets, and regulators acknowledge that such acquisitions ‘help to promote an efficient, dynamic and innovative business sector’ (Reserve Bank of Australia, 2007: 66).

Private equity plays an increasingly important role in a number of industries. Early - stage (‘venture capital’) investors have been active in the biotech industry for a long time. Most late-stage (‘buyout’) investors, however, have steered clear of pharmaceutical R&D and generics companies (Sommerfeld, 2005).

In Europe, private equity investments by sector situation in 2013 is as follows (% of Amount): Business & industrial products – 14.1%; Consumer goods & retail – 13.8%; Life sciences – 13.1%; Consumer services – 9.4%; Business & industrial services – 9.4%; Communications – 9%; Computer & consumer electronics – 7.4%; Energy and environment – 6.8%; Financial services – 6.2%; Transportation – 3.6%; Chemicals and materials – 2.3%; Agriculture - 2.1%, Construction – 1.2%; Real estate – 0.3%; Unclassified – 1.2% (2013 European Private Equity Activity).

Conclusion

Private equity operators and venture capitalists are just a sample of the groups in the financial system. They represent one of the various options that entrepreneurs consider to finance their business. However it found numerous empirical studies, statistics suggest that successful in certain situations because of peculiarities that differentiates itself from other firms financing options: for young firms or a new business idea; the acquisition of long-term growth potential target firms, with the aim of restructuring the firm to improve its value; funding source companies not listed on a stock exchange, in various stages of development, etc.

In literature and statistics provided by associations, studies differently focuses on venture capital component or component Buy Out. Buyout operations recorded the highest value of transactions due to their high dimensions compared with other investments. In literature and statistics provided by associations, studies differently focuses on venture capital component or component Buy Out.

Private equity financiers support firms with their skills, competencies, know-how, etc. Because this creates value for funded firms, the investor allows the entrepreneur to take value from the funded idea. In most cases, without private equity or venture capitalists, firms would not be able to develop projects.

Private equity investor preferences are determined by macroeconomic factors, the characteristics and the location businesses, sector in which the firms operate.

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