

Welcome Pack

A Beginners' Guide to PE and VC

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What are PE and VC?

Private equity and venture capital

For people who do not work in the finance industry, the world of private equity (PE) can seem somewhat daunting. There are numerous acronyms and even trying to explain what private equity is can be mind-boggling. So, in its simplest terms, what is private equity?

Private equity IS a type of investment.

Private equity and venture capital firms (or funds) invest money by buying all, or part of a business with the intention that this business will grow in value and can be sold at a later date for more money than the business was purchased for.

Private equity (PE) and venture capital (VC) firms will seek to make a profit (known as a return on investment) by growing and improving the company, using not only finance but also their own commercial expertise and business acumen.

A large variety of businesses in different industrial sectors benefit from private equity and venture capital investment, including those operating in technology, manufacturing, healthcare, consumer services, financial and other business areas.

Here are some famous names you may know, all of which are backed by UK private equity and venture capital



Why are PE and VC important?

It isn't just investors that benefit from private equity; our industry delivers for institutional investors and for the wider economy, providing investment, employment, driving innovation and building British businesses. It is, quite simply, funding the future.



2 million people

employed in the UK by companies backed by private equity and venture capital



1,320 UK companies

received investment from private equity and venture capital in 2021



5,000+ businesses

currently backed by UK private equity and venture capital



9 in 10 investments

directed at SMEs (small to medium-sized enterprises) from private equity and venture capital in 2021



£17.3bn invested

into UK companies from private equity and venture capital in 2021



£16.7bn raised

from private equity and venture capital in 2021

Why are PE and VC important?

Private equity firms generally invest in large, well-established companies, whilst venture capital firms invest in start-up/early stage companies. Both private equity and venture capital firms usually only invest in unquoted businesses; this means the company is not listed on a stock market and therefore cannot sell (trade) part or all of its investment on a daily basis. This is referred to as being illiquid.

(It should be noted that the terms 'private equity' and 'venture capital' are often used interchangeably, particularly in the media. Often 'private equity' is used to refer to both private equity and venture capital, and conversely the same also happens with the term 'venture capital').

The time duration for each investment varies but, generally, it will last between four and seven years before the PE or VC firm sells the stake it has acquired. This means there is a commitment to each and every business by building lasting and sustainable value. It is without doubt that creating value in a business is key to the private equity and venture capital model.

So where do PE and VC firms obtain the money to invest in these businesses?

Private equity and venture capital firms raise funds to buy businesses from institutional investors like pension funds, insurance companies, sovereign wealth funds and family-offices. For these investors, private equity and venture capital is an "asset class" which has consistently delivered strong returns and continuously outperforms other asset classes, including stock markets. Its ability to produce returns even during times of economic downturn makes private equity and venture capital very attractive to investors.



BVCA Report on
Investment Activity

How it all works

Private equity and venture capital are different but both share some essential similarities in that firms raise money from institutional investors, they pool this capital (money) into funds, and then they use these funds to invest in companies for an equity stake which they will eventually sell. The profit made from this sale is then returned to the investors in the fund.

The primary difference between private equity and venture capital is the type of companies they typically invest in. Venture capital firms are generally interested in backing young, early-stage companies whilst private equity will be looking for more mature and more established businesses.

VC firms will generally take a minority equity stake (<50%) in a company – often alongside other venture capital firms – whereas private equity firms will generally take larger stakes, often acquiring a controlling majority share (>75%) and buyout the entire business. At the same time as a private equity firm makes an investment in a company, it will use bank debt or other debt capital raised alongside its own equity to ‘leverage’ its investment to fund the acquisition. ‘Leverage’ is simply another term used to mean debt borrowed from a bank (or similar institution). One way to think of it is like buying a house: the buyer will invest their own money (as equity) for a certain percentage of the total cost of the house and then borrow the rest from a bank in the form of a mortgage (debt).

How it all works

Venture capital firms will generally hold onto an equity stake for a longer period of time than a private equity firm due to the nature of investing in early-stage businesses, which can often take a long time to grow and start making a profit.

In between private equity and venture capital is an increasingly important type of investment called growth capital. Broadly speaking, firms specialising in growth capital will invest in companies that are more mature than those acquired by a VC firm, but the businesses are not yet mature enough for a private equity firm. A growth investment will be used to develop a particular area of the business.

Despite these differences, every equity stake, be it from a VC firm or a PE firm, will at some point be sold. The goal over the course of the investment – or ‘hold’ – period is the same: to ensure the business has improved over that time and is more valuable at the end of the hold period than at the start of the investment. This increase in value could be because the business has increased profits, acquired other businesses, expanded into new markets or overseas, or launched new products.



How it all works

Time to exit

Once a company is in such a position, there are a number of options for a private equity or venture capital firm wishing to sell their stake or 'exit' their investment.

Firstly, they may sell their stake to another company, generally to a larger one than the one being sold. This is known as a 'trade sale'. For example, if you have a great tech start-up, you may wish to sell this to a company like Google or Apple.

A second option is to list (put) the company on the stock market, also called a 'float' or 'IPO' (Initial Public Offering). By listing the business on the stock market, the VC or PE investor will typically sell part of their stake on the first day the company 'floats' and then they will sell off the rest of their stake over a period of time.

A third option is to sell to another venture capital or private equity firm. This rarely happens with venture capital – although sometimes venture capital firms will sell to private equity firms – but it is quite common for private equity firms to sell to one another. This is known as a secondary buyout and will typically involve a smaller private equity firm selling to a larger private equity firm who will help the company grow even further.

Skin in the game

One of the most important aspects of the private equity and venture capital model is the fact that the PE and VC firm will invest its own money into its funds alongside that of the capital raised from institutional investors.

This is to ensure the fund manager – or 'General Partner' (GP) in industry jargon – has 'skin in the game', i.e. that they are sufficiently motivated to make the fund as successful as possible. If you want to get technical, the phrase for this concept is 'alignment of interests'.

How it all works

All of this capital is put into a fund structured as a Limited Partnership which is then managed by the General Partner. The institutional investors are also known as 'Limited Partners', or LPs for short.

When the time comes to sell a stake in the company, all of the investors in the Limited Partnership will, assuming the investment has been a successful one, share in the profits made. However, it is the LPs – i.e. the pension funds, insurance companies, etc – who first receive any returns generated. The fund manager – the GP – will only receive their share of the return when the level of return has surpassed a certain point. This point is known as the 'hurdle rate' and will be agreed between the LP and the GP. Once the hurdle rate has been exceeded, then the GP will start to take their share – this is known as 'carried interest'.

Public ownership versus private equity

Public ownership (when a company is listed on the stock market) has a number of fundamental differences compared to the private equity investment form of ownership.

A typical public company will have in the region of 100,000 shareholders, very few of whom will be able to exert any meaningful influence. A private equity-backed company, by contrast, will have, usually, just one shareholder (the private equity firm) in addition to the management team. This usually results in short reporting lines between the shareholder and management, thus enabling the private equity-backed business to be agile and make decisions faster, and as such, the management team can focus on the real issues of running a business. Private companies also do not have to comply with the regulations that public companies must adhere to.

Stock markets often undervalue companies because shareholders are unable to fully support the investment in terms of time and capital which are essential ingredients for a company if it wishes to deliver its full potential.

How it all works

Conversely, the private equity industry is often best placed to realise hidden value from such companies because of the unique way that it owns and governs businesses and its longer-term investment horizons.

Types of investment

There are a wide range of PE and VC investments but the most common types of investment are as follows:

Seed and early-stage

As the name suggests, this type of investment is for young (very young in the case of seed investments) companies and are primarily the domain of “Angel Investors” and venture capital firms. Seed and early stage investments are often distinguished by the ‘round’ of investment. ‘Rounds’ are when a company takes on a fundraising drive to raise capital, often from a number of different Angel Investors or VC firms.

The funding rounds begin with a ‘seed’ investment and is followed by A, B, then C funding rounds, with the amount of capital being raised increasing on each round. Sometimes you will also see D and even E funding rounds, but very rarely more than this.

The main differences between rounds of investment are the maturity levels of the businesses, the type of investors involved, the purpose of raising capital, and how it is ultimately allocated.

How it all works

Growth capital

As briefly mentioned above, growth capital sits between venture capital and private equity. Whilst many early-stage businesses will not yet be making a profit, growth capital investments tend to be in companies that are in the later stages of development and are a bit older, larger, generating a profit, and have identified an area for new business growth that needs additional capital to support the growth. Growth capital usually takes the form of a minority investment – i.e. not a controlling stake.

Buyout

There are a number of different types of buyout – management buyout, leverage buyout, secondary buyout, to name just a few – but the most important thing to remember is that the term refers to a private equity firm buying a controlling equity stake in a company. Buyouts range from the acquisition of relatively small businesses to very large ones, and can involve tens of millions of pounds right up to hundreds of millions and in some cases billions of pounds.

Please carry on reading to find out more details of the BVCA's official investment terminology which is used by our own Research team.



Job titles and responsibilities

There are a myriad of job titles used among our private equity and venture capital (GP) members, so many that it can appear confusing even to a veteran of the industry. To make matters worse, different member firms often use job titles differently. For example, at one firm a manager might be a more senior position, whereas at another firm it could be a more junior one. At some firms, the managing partner is the head of the firm, at others the most senior position could be the CEO.

However, there are some commonalities and the below guide – listing titles from senior to junior - will give you a good indication of how senior someone is and what their responsibilities are. However, this is just a guide so if you are ever in doubt, don't hesitate to ask one of your team members.

Partner

Sets the overall strategic direction and leadership of the fund with ultimate responsibility for raising funds for investment and delivering the anticipated returns to investors. Typical job titles may include (but are not limited to) the following:

Managing Partner, Partner, Operating Partner

Investment Director

Works with senior leadership to develop and deliver the fund strategy

Typical job titles may include (but are not limited to) the following:

Investment Director, Director of Private Equity,

Director of Venture Capital, Fund Director

Job titles and responsibilities

Investment Manager

Works with the senior deal team to deliver the fund strategy
Typical job titles may include (but are not limited to) the following:
Investment Manager, Principal, Fund Manager

Investment Analyst

Sources investment deal opportunities and supports the senior deal team with fundraising and management of funds. Typical job titles may include (but are not limited to) the following: *Origination Analyst, Investment Analyst, Associate, Investment Associate, Investment Executive*



Commonly used words & phrases

As you will shortly discover, if you haven't already, this is an industry with lots of jargon and acronyms. Below is a list of some of the most commonly used terms, but it is in no way comprehensive, so please do not be afraid to ask a colleague if you come across a piece of terminology you do not understand, or alternatively check out the BVCA website.

Angel investors

Or business angels. These are high-net worth individuals who invest their own money into very young companies in exchange for an equity stake. Angel investors will typically invest in younger and smaller companies than a venture capital firm.

Asset class

An asset class is a category of investment which has similar financial characteristics and behaves similarly in the marketplace, for example Cash, Shares, Property and Bonds.

Assets under management (AUM)

This means the total value of all the companies a venture capital or private equity firm is currently invested in.

Capital

Money.

Cash multiple

A measurement of the return generated by an investment.

Carried interest

Also known as carry: this is the share of the profits generated by an investment that is paid to the GP.

Corporate venture capital

A type of venture capital. Rather than a standalone – independent – fund, corporate venture capital funds will be part of a large company and will invest in early-stage businesses on their behalf.

Commonly used words & phrases

Crowdfunding

Type of investment where a business raises money from a large number of people who each contribute a relatively small amount.

Equity

Shares issued by a company.

Exit

When a fund sells its equity stake in a company.

Fund-of-funds

A fund which raises money from institutional investors to invest into private equity and venture capital funds.

Fundraising

When a VC or PE firm raises capital from institutional investors to form a fund.

General Partner (GP)

Another name for a private equity or venture capital firm or fund manager.

Impact investment

Also known as social investment, or social impact investment. These are investments made into companies, organizations and funds with the intention to generate a measurable and beneficial social or environmental impact alongside a financial return.

Institutional investor

See Limited Partner (LP).

Investee company

A company which is currently invested in by a private equity or venture capital fund. Also known as a portfolio company.

IPO

Initial Public Offering. The very first sale of a company's shares to the public via the stock market. See listed/quoted company.

IRR

Internal Rate of Return. A measurement of the return generated by an investment. It calculates the return by looking at all of the cash flows from the investment over a given time period.

Commonly used words & phrases

Leverage

A private equity firm may use leverage (debt) to purchase a company alongside their own investment. A deal using leverage is often called a 'leverage buyout' or 'LBO'.

Limited Partner (LP)

Another name for an investor in private equity and venture capital funds. Typically LPs are institutional investors like pension funds, insurance companies or sovereign wealth funds. They can also be Fund-of-funds (see 'Fund-of-funds').

Listed/quoted company

A public company with shares listed for trade on the stockmarket.

Listed private equity

Private equity funds that are listed on the stock market and raise money from the stock market to invest.

Management fees

These are fees paid by LPs to the GP for managing the fund. They are used to pay for the day-to-day operations of the GP, such as salaries, office rent, utilities bills etc.

Management team

The senior managers of a portfolio/ investee company, i.e. CEO, COO, etc.

Portfolio company

A company which is currently being invested in (or backed) by a private equity or venture capital fund. Also known as an investee company.

Public company

A company that is listed on a stock market such as the London Stock Exchange, New York Stock Exchange, the Hang Seng (Hong Kong stock market) etc.

Commonly used words & phrases

Trade sale

When a fund sells its equity stake to another business, a form of exit.

Responsible investment

An approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions to better manage risk and generate sustainable long-term returns.

Returns

The profits made by a VC or PE firm when they sell an equity stake. There are a number of different ways of calculating returns but the two most common are IRR (Internal Rate of Return) and cash (or money) multiple.

Return on investment

Return on investment is a performance measure used to evaluate the efficiency of an investment. To calculate the return on an investment, the benefit/profit (or return) of an investment is divided by the cost of the investment.

Round

When an early-stage company raises money from VC investors, this is called a round. Rounds can happen in intervals, starting with a Seed round followed by Series A, B and C rounds.

Venture Capital Trusts (VCTs)

A type of venture capital fund that is listed on the stock market and which invests in small companies.

Official BVCA investment stage terminology

Here are the official BVCA definitions of the various different stages of investment in our industry. These phrases are most often used by our Research team when compiling their reports.

Add-on/Bolt-on/ Build-up/ Acquisition

The purchase of a company by an existing portfolio company funded by a private equity fund.

Bridge equity financing

Financing made available to a company in the period of transition from being privately owned to being publicly quoted.

Buyout

Financing provided to acquire a company, typically by purchasing majority or controlling stakes. It may use a significant amount of borrowed capital to meet the cost of acquisition.

Growth capital

A type of private equity investment (often a minority investment) in relatively mature companies that are looking for primary capital to expand and improve operations or enter new markets to accelerate the growth of the business.

Later stage venture

Financing provided for an operating company which may or may not be profitable. Late stage venture tends to be financing into companies already backed by VCs. Typically in C or D rounds.

Other early stage

Funding provided to companies that have initiated commercial manufacturing but require further funds to cover additional capital expenditure and working capital before they reach the break-even point. They will not be generating a profit yet.

Official BVCA investment stage terminology

PIPE

Generally referring to a private investment in public equity (PIPE).

Seed

Funding provided before the investee company has started mass production/distribution with the aim to complete research, product definition or product design, also including market tests and creating prototypes. This funding will not be used to start mass production/distribution.

Public to Private

Purchase of quoted shares with the purpose of de-listing the company from a stock exchange.

Refinancing bank debt

Funds provided to enable a company to repay or restructure existing bank debt.

Replacement capital

Minority stake purchase from another private equity investment fund or from another shareholder or shareholders.

Rescue/Turnaround

Financing made available to an existing business, which has experienced financial distress, with a view to re-establishing prosperity.

Secondary Buyout

Financing provided to acquire a company from another private equity firm. It may use a significant amount of borrowed capital to meet the cost of acquisition.

Start-up

Funding provided to companies, once the product or service is fully developed, to start mass production/distribution and to cover initial marketing. Companies may be in the process of being set up or may have been in business for a shorter time, but have not sold their product commercially yet. The destination of the capital would be mostly to cover capital expenditure and initial working capital.

Further reading

If you still want to know more about private equity and our industry why not visit some of the websites below.



BVCA website

www.bvca.co.uk



A Guide to Private Equity

Dated in parts (it was published in 2012) but still good on the essentials



Finance Hub

A British Business Bank website for businesses seeking investment



The Business Finance Guide

A dedicated microsite from the British Business Bank



Private Equity Demystified

By the Institute of Chartered Accountants in England and Wales (2014)



Private Equity Made Simple

by the trade association for pension funds (2014)



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