The AUSTRALIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION Limited

Private equity and venture capital explained
Fact sheet

This fact sheet gives an overview of the private equity (PE) and venture capital (VC) industry in Australia. It explains what PE and VC are and how they operate.

What are PE and VC?

PE and VC firms are fund managers that generally invest in companies that are considered to have high growth potential. These companies may be distressed or in need of capital to expand. In the case of VC, the commercial potential may still only be a concept. PE may also buy part or all of a public company, but this is less common.

A wide variety of businesses in various industry sectors benefit from PE and VC investment. The main sectors are life sciences, energy and environment, business and industrial services, consumer services and retail, communications and financial services.

PE and VC inject hundreds of millions of dollars each year into the Australian economy. PE and VC are considered an "alternative asset class", meaning they are not a mainstream investment type like listed equities, debt instruments or term deposits.

Sources of funding

PE and VC firms raise their funding from institutions and, in some cases, high net-worth individuals. PE investors seek exposure to long-term investments with stable performance returns. VC sits higher on the risk-reward equation. As a result, VC investors are looking for higher reward outcomes to offset the higher risk profile. Australian superannuation (pension) funds are important investors in domestic PE and VC funds, although foreign-sourced funds are increasingly being accessed. PE and VC fund managers often invest some of their own capital, too.

The PE and VC managers of the fund are described as general partners (GPs) because they manage the fund and are liable for its legal debts and obligations. The investors are described as limited partners (LPs) in the fund because their liability for debts and obligations of the fund is limited to the amount of their investment in the fund. LPs are passive investors because they are precluded from getting actively involved in the management of portfolio companies.

PE and VC characteristics

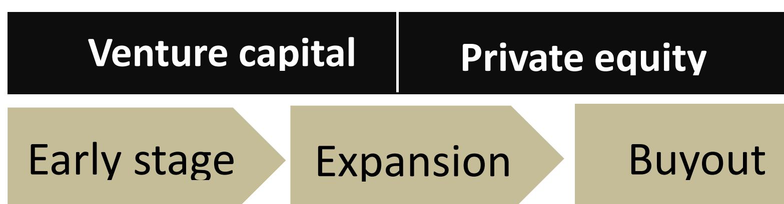
PE and VC investments have several characteristics that set them apart from other forms of business ownership, particularly the public markets.

- *Alignment of interests*. This has two aspects. Firstly, there is the alignment of investor and GP interests through legal agreements and performance fees. Also, GPs usually co-invest their own money up to a certain amount (generally 2% to 5% of the fund) to further demonstrate their commitment and alignment of interest with the LPs. Secondly, the investee company management ownership model aligns the interests of senior management with other shareholders.
- *A long term investor*. PE and VC develop a comprehensive long-term plan together with company management to grow the business and increase its value. PE and VC investments have an average five- to seven-year holding period and place long term growth in underlying value ahead of short term profit considerations. This ownership period is considerably more than the average holding period of ASX stocks at 1.2 years.
- *Detailed due diligence*. Before investing in a business, PE and VC firms conduct a thorough analysis to gain a detailed insight into the business's strengths and weaknesses, its growth potential and the prerequisites for achieving this growth.
- *Active stewardship and expertise*. Representatives of PE and VC firms actively focus on matters such as strategic planning, recruitment of senior managers, access to important networks and international markets, thus bringing far more than just capital to the table. PE and VC firms usually have one of their partners as a board member of the investee company, and bring strong governance systems and processes to investee companies.

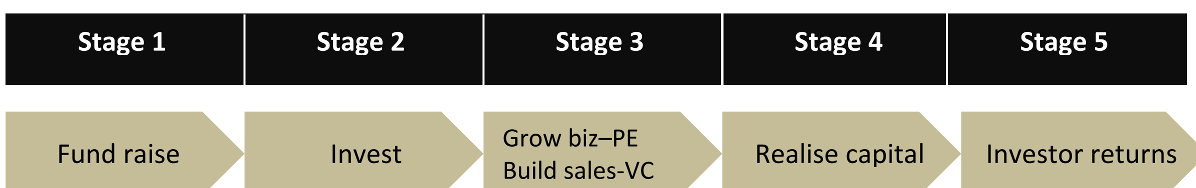
Stages of VC and PE

VC and PE generally invest in different stages of companies. While VC usually invests in early stage firms and PE generally invests in growth/expansion and buyout stages, there are areas of overlap.

Stages



Life cycle



PE/VC funds are "closed-end" with a life of typically 10 to 12 years. LPs remain committed to the fund for the life of the fund. Their investments are typically long-term with average holding periods of five to seven years.

Unique VC characteristics

VC firms generally invest in early stage companies, although they also invest in expansion stage businesses (later stage VC). They usually invest in companies that have developed new technologies,

systems and processes, rather than established technologies. As a result, VC is a fundamental link in the national innovation system. It provides capital and commercialisation skills to some of the country's top scientific, technical and entrepreneurial brains, to help make Australian innovation a commercial success.

Without a thriving VC industry, many Australian inventors and entrepreneurs – from biotechnologists through to software developers and industrialists – would be unable to bring their innovations to market. VC is considered a high risk investment because the funding is often at the development phase of a concept that is yet to prove its commercial worth. The VC's goal is to grow the company to a point where it can be sold at a profit.

Many venture capitalists come to the industry after their own successful careers as scientists, engineers, doctors or entrepreneurs. VC firms generally do not use leverage (i.e. debt) in their transactions, and invest for an average period of seven years.

Unique PE characteristics

PE usually buys into established businesses with growth potential. Some investee companies may be distressed or facing bankruptcy. The areas where PE firms have the greatest impact are with companies needing more management attention, strategic direction and investment capital. PE fund managers become actively involved in the strategic process and management of a company.

PE will finance its acquisitions through a combination of equity and debt. Compared to VC, PE firms have larger investments in fewer companies, and invest for an average period of five years. The greatest gains in enterprise value are achieved by growing the core business and operational revenues.

The investment model

Globally, a typical PE and VC fund structure involves a collective investment vehicle (CIV), such as a limited partnership or a trust. PE and VC funds raise capital by securing capital commitments from investors. These are pledges of capital to the PE or VC fund. The GPs invest the fund's capital across a set of investments that fit the fund's investment mandate or focus.

Capital is gradually drawn down from LPs over the life of the fund through a series of "capital calls" as and when investments are made (typically during the first five years). A PE firm may operate a number of funds, and each fund typically will invest in a number of companies. PE and VC firms generally co-invest a certain amount of their own money to further align the interests of investors and fund managers. Once an acquisition has been made, a representative of the PE or VC firm usually joins the company board and actively works with the investee company during, and often after, the investment period.

This form of investment is very different to those of other investment types, such as listed equities where the manager merely makes a transaction via a computer screen and then passively watches the performance. After an average period of five to seven years, PE and VC funds exit investments to realise a return for investors. Most divestments take place via trade sales. Some are secondary sales (to

another PE or VC firm) and some are divested via a share market listing (or Initial Public Offering or a share buyback.

Industry investment practices

AVCAL members adhere to a set of standards to ensure consistent reporting to investors. This is achieved through the use of an industry investment reporting guide, a guide for the valuation of assets, a code of conduct, a code of corporate governance, and the embedding of global industry environmental, social and governance (ESG) practices for the PE industry.

The formalisation of good governance practices for Australian PE firms demonstrates that the industry holds itself up to high standards. PE firms must also adhere to other regulatory requirements (such as corporations law and tax obligations, where applicable).

Fees and returns

Once a fund is raised, GPs begin to receive a management fee based on the size of the fund. The management fee is negotiated between the LPs and GPs at the time the funds are raised and usually calculated as a percentage of the funds committed to the fund. An indicative figure is 2% per annum for smaller funds and 1% to 2% for larger funds. This figure covers the overheads of the business including salaries and the costs of conducting due diligence on investments.

LPs only realise gains when distributions are made. The legal documentation governing each fund requires that all investments of the fund be realised and the funds returned to the LPs immediately upon divestment. LPs may also occasionally receive some interest and dividend income from the private equity fund. These amounts are typically only a small proportion of their investment returns, and may also be reinvested back into the fund.

If the investment's returns exceed a predefined hurdle rate, usually around 8%, GPs receive a share of the realised gains (known as "free carried interest"). This is typically calculated net of management fees and only distributed after actual cash returns have been delivered to the LPs. Globally, LPs favour this key feature of PE funds because it aligns their interests with those of the GPs. Internationally, regulators also recognise that the payment of carried interest as described above is a key "good practice" characteristic in the private equity industry that aligns interests between private equity managers and fund investors.