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The Association of Investment Companies

# Private equity investment companies

Private equity investment companies are listed companies which invest directly in unlisted companies or in funds which invest in unlisted companies. Private equity aims to add value and develop businesses in order to increase their long-term value, so that they can eventually be sold or floated at a higher price, thus generating a profit for shareholders.

Private equity investment companies can make an important contribution to the economy in a number of ways, by providing capital and strategic and operational expertise for businesses. This can help to promote competitiveness, locally or internationally, encourage innovation and increase employment. Investing in a private equity investment company enables you to gain exposure, at a relatively low cost, to a professionally run portfolio of privately owned shareholdings. Privately owned companies are assets which are difficult to invest in directly due to the high level of capital and experience required.

With any equity investment your money is at risk. However, you should remember that private equity investment companies are buying shares in privately owned businesses that vary from small or young companies to larger companies. Younger companies, due to their stage of growth, should be viewed as higher risk than larger, more established companies. However, with greater risk, there is potential for generating a greater return.

Private equity investment companies can be based offshore or in the UK and are subject to the tax rules and company law of their domicile. They are also subject to the rules of the stock exchange on which their shares are traded.

## What is private equity?

Private equity is investment in unlisted companies that are privately – not publicly – owned, meaning that they are not traded on a stock exchange. Most private equity investment is conducted by private equity firms that raise funds to invest in potentially high growth businesses or for acquiring businesses which could be made more efficient (and hence more profitable). The term “private equity” embraces management buy-outs and buy-ins, development capital and venture capital, which is investment in start-up and early-stage companies.

## How does it work?

The private equity process typically involves a private equity firm raising money from investors which is then invested by buying majority or minority stakes in unquoted companies that meet the fund’s investment criteria. The private equity fund manager will often actively help the companies in which it invests to develop, restructure and grow profitably. This usually involves taking a seat on the board and providing a range of assistance, including strategic advice particularly on capital markets and financing, market analysis, networking and sourcing additional or professional management.

When an investee company has reached the strategic goals set out for it by the manager, then the manager may seek to refinance the company or it may be sold to a larger company, floated on a stock market or sold to another private equity firm, whose focus on specific industry sectors, geographies or the stage of the company’s development might bring added benefit to the company’s further growth.

## What about debt?

Apart from early stage companies, many private equity investments are also financed with debt. The use of debt in addition to equity is known as ‘financial gearing’. Debt is often repaid from the cash flows of the investee company, but as a company progresses, it may equally be able to support a higher degree of debt, allowing repayment of the equity capital to the private equity investors.

Levels and types of debt take into account the capital structure and cash flow of the investee company, prevailing interest rates and the opportunities for acquisitions and internal investment. Debt can be increased or decreased through the life of the investment in order to achieve the most cost-effective deployment of capital. It is important to understand that the effect of financial gearing is to magnify performance, so if the investee company’s performance is strong, gearing will boost the performance but, when the investee company’s performance is poor, the losses suffered will be amplified.

## How do private equity investment companies work?

There are two types of listed private equity investment companies - those which invest directly in unlisted companies and those that invest in funds which invest in unlisted companies (fund of funds). Some private equity investment companies invest in both direct investments and funds offering a hybrid of the two approaches set out below.

### Direct investors

The investment company has a private equity team who invest directly in unlisted companies, subject to the stated objective of the company. The managers' aim is to help these companies develop and progress, and sometimes restructure, in order to increase the long-term value of the companies so these companies can be sold at a profit.

### Fund of funds investors

In a fund of funds, the investment company invests in a portfolio of private equity funds which invest in unlisted companies. Funds of funds aim to diversify across a range of investment strategies and different sectors providing access to a range of managers.

### Closed-ended

At launch, private equity investment companies raise money for investing by issuing shares. Generally this happens once – when the company is created. This makes private equity investment companies closed-ended i.e. the number of shares the company issues is fixed at the outset. The closed-ended structure of an investment company is particularly suited to private equity as private companies can be difficult to sell (illiquid) in certain market conditions, but the structure allows a manager to take a long term view because they do not have to sell investments to meet redemptions from investors.

### Specialised objectives

Each private equity investment company has its own investment objective which will be clearly stated in its literature. Each company will also have its own individual investment strategy referring to the size and type of investments and any specific industry sector, where it invests and specific transaction types such as start-up, expansion, buy-out or turnaround. This will be explained in more detail in the report and accounts and other documentation.

### A board of directors

Each private equity investment company has a board of directors that monitors the company's performance. The board of a private equity investment company has a legal duty to uphold the interests of its shareholders.

### Private equity managers

The board normally appoints a private equity manager to manage the fund and its portfolio of investments on a day-to-day basis. In a few cases the private equity investment company owns the manager and a small number of private equity investment companies are self-managed by their directors.

### **Charges**

Due to the way that private equity investment companies are managed (i.e. the specialist expertise involved in managing this type of investment) the costs involved in running the company are generally higher than the average investment company. This reflects the additional costs involved in taking a more active role in managing the portfolio companies. These costs, commonly shown as a Total Expense Ratio (TER), affect the returns available to shareholders. As with many other collective investments, private equity investment companies may also charge performance fees. If you want to know more about TERs please see the AIC website and the individual private equity investment companies for more specific information.

### **Tax**

Like all investment companies, capital gains made on the disposal of portfolio investments within the private equity investment company are not subject to capital gains tax.

### **Eligibility for an ISA**

The vast majority of private equity investment companies qualify for Individual Savings Accounts (ISAs), but there are some exceptions. If you have any doubts please check with the individual company to find out whether they are eligible for an ISA.

## What are the benefits?

### Allows private investors to access private equity

Private equity is difficult to access for most private investors. A private equity investment company allows private investors to gain exposure to a professionally run portfolio of privately owned shareholdings.

### Allows you to pool your money

When you purchase shares in a private equity investment company, you pool your money with other investors, providing potential economies of scale, in terms of transaction costs and administration.

### Allows you to spread your investment risk

Each private equity investment company invests in a range of companies or a number of funds investing in a range of companies. So buying shares in a private equity investment company effectively gives you a diversified portfolio in this specialist sector.

### Specialist professional management

Private equity investment companies use the expertise of professional private equity managers. In the case of direct investors, these managers aim to develop their investee companies or make them more efficient by actively working alongside the investee company's management to pre-agreed plans and targets. At least one member of the private equity team will usually be a director of the investee company. In the case of funds of funds, the expertise of the manager is important when it comes to analysing and deciding in which funds to invest.

### Nature of investee company shareholders

The private equity investee companies have a limited number of highly incentivised shareholders, including management, all working to pre-agreed plans, targets and objectives.

### Allows you to invest small amounts

You can invest small lump sum amounts or even invest monthly. Some of the managers run savings and investment schemes and all the private equity investment companies are available through stockbrokers' saving and investment schemes and ISAs.

## How do private equity investment companies differ from other investment companies?

### Illiquid nature of investments

Investments by private equity firms are typically held for several years, depending on the stage of the businesses, their success, growth prospects and market conditions for selling or floating the business. Early stage investments can be held for many years, during which they may be refinanced, while they develop into mature businesses.

If a company is underperforming, the private equity investor will usually move quickly to restructure, refinance or change management strategy, but it may also decide to cut off further funding quite early on. The aim is always to achieve the best return on each investment, however and whenever that can be achieved. Due to the nature of unquoted companies it may not be easy to sell them, for example, if poor market conditions are not conducive to a sale or flotation or to obtaining debt. This type of investment which is relatively difficult to sell (convert to cash) is known as an illiquid investment. In contrast, many investment companies invest in public companies which can almost always be sold if cash is required, although prices will vary depending on market conditions. This type of investment which is relatively easy to sell (convert to cash) is known as a liquid investment.

### Long-term view

Due to the relatively illiquid nature of private equity companies' investments they should be considered long-term investments. You should ensure that the investment risks and potential rewards are considered before making any investments. As with any equity investment, returns are not guaranteed and you may get back less than you invested or, in extreme cases, nothing at all.

### Valuations

Because the shares of unquoted companies are not freely traded on any recognised stock exchange, it is more complex to establish their current market value. The board of directors can use valuation methods, based on established principles, to estimate the value of each private company shareholding. It should be remembered that they can only be estimates and may not actually reflect the value realised on any subsequent sale, which is dependent on there being a willing buyer in the market and the price they are prepared to pay at that time.

### Net Asset Value and share price

Due to the nature of their portfolios, private equity investment companies are often only able to produce Net Asset Value (NAV) figures on a quarterly or half-yearly basis. This means that the NAV will move less frequently than investment companies investing in some other assets. You should therefore bear in mind that, in addition to the difficulty in valuing unquoted investments, the published NAV may have been calculated some weeks, or even months, earlier. You should remember that the share price value of the private equity investment company will depend on the performance of the underlying assets and demand for the shares.

### How to invest

#### Investing with advice

You can go to a professional adviser, who will give you advice on what to invest in. Together you can work through all the different factors that may affect your decision. Your adviser can then advise you on whether private equity investment companies are a suitable investment for you.

The AIC website [www.theaic.co.uk](http://www.theaic.co.uk) has further information about obtaining financial advice or you can find a Certified Financial Planner by calling the Institute of Financial Planning on 0117 945 2470 or by going to [www.financialplanning.org.uk](http://www.financialplanning.org.uk).

#### Investing without advice

If you are prepared to select your own private equity company you can choose whether to go direct to a stockbroker or an execution only dealing service to buy shares for you. Or you can approach a fund management group to invest via a wrapper product such as a savings scheme or ISA. The AIC website [www.theaic.co.uk](http://www.theaic.co.uk) has further information on member private equity investment companies and wrapper schemes. However, if you are in any doubt you should seek specialist advice.

### Key things to remember

- Private equity investment companies invest in unquoted companies. These vary in size from small to larger companies and should be viewed as higher risk than investing in public companies. Due to the relatively illiquid nature of unquoted companies, private equity investment companies should be viewed as a long-term investment.
- Private equity investment companies allow investors of moderate means access to an asset class which has traditionally only been available to wealthy and institutional investors.
- The closed-ended nature of investment companies is suited to private equity investing because the manager has a stable pool of money to invest and can take a long-term view.
- As with any equity investment, returns are not guaranteed and you may get back less than you invest or, in extreme cases, nothing at all.
- If you are unsure whether private equity investment companies are suitable for you, you should take professional advice.

## For further information

### Visit our website

Our website is a good place to start if you want to learn more about investment companies and find detailed information on all our member companies. You can find it at [www.theaic.co.uk](http://www.theaic.co.uk).

### Information factsheets

The AIC publishes a range of factsheets which are available free of charge by calling 0800 085 8520 or can be downloaded from our website.

### LPEQ

For further information on private equity investment companies see [www.lpeq.com](http://www.lpeq.com), a trade group providing research and information on this sector.



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