

What is Private Equity?

Private Equity › Interview Preparation



Investment Banking, Private Equity
& Venture Capital Articles, Guides & Jobs

Private equity funds are private pools of money managed by "general partners" who aim to generate a return to the investors ("limited partners") who are investing their money in the fund. Private equity funds can manage anything from £50 to 100 million to several billions.

The general partners will charge a percentage fee of the total amount that they manage (typically 1.5% to 2% per year) and they will also keep a share of the profits they generate (usually 20%). Private Equity is called "private" because it is a source of funds that do not originate from "public" sources such as bonds or listed equity. The funds are used to invest in companies, usually acquiring a significant stake to gain control over the firm's management. When a private equity firm makes an acquisition, they use significant amounts of debt, and therefore such acquisitions are called "Leveraged Buy Outs" or LBOs. The practice of LBOs was pioneered by firms such as Kohlberg, Kravis & Roberts (KKR) in the 1970s and over the last three decades, LBOs have assumed roles of ever-greater importance in the financial world.

How does an LBO work? How do they make money?

Private Equity funds buy companies using significant amounts of debt instead of their own money, which holds a number of advantages:

1. Interest on debt is tax-deductible.
2. If the company has a lot of debt, a small change in its overall value will have a strong impact on the equity value (i.e. the money invested by the fund). This effect is called "gearing". A simple example: imagine you buy something for £10 by borrowing £9 and using £1 of your own money. Three years later, it is worth £12 (20% increase). You pay back the £9 of debt and you keep the £3 extra, so you made 300%! In real life, the process is complicated by taxes, interest, and debt repayments but the theory is the same. Bear in mind that the interest you pay on the debt is fixed, so the private equity firm can pocket all the extra return.
3. Because cash flow is tight due to debt repayment, debt keeps management disciplined.
4. Most LBOs are structured so that management is also given a substantial incentive to perform in the form of equity.

5. Private Equity funds will then help the company to achieve an optimal strategy (i.e. revenue growth, cost-cutting) with the aim to exit and sell the company within four to five years (after some of the debt has been repaid), either to another company, another private equity fund, or through an IPO.

How are they different from venture capital or hedge funds?

Venture Capital firms invest in early-stage companies (or "start-ups"), and make smaller investments (a few millions at maximum). Venture Capital firms also target very high-growth companies with huge potential, i.e. Internet companies such as Facebook, Google, and other innovative technology firms in healthcare, renewable energy, biotech, etc. but that also have more potential to go bust! Hedge Funds invest in publicly listed securities and usually do not seek to gain control of companies they invest in. Also, hedge funds tend to appeal to very short-term investors (from days to less than one month).

Where does the money come from?

Wealthy individuals, pension funds, and mutual funds are the typical investors in private equity funds.

What kind of companies do Private Equity funds buy?

Because LBO returns (on average 20-30% over four to five years) can only be achieved with a lot of debt and good growth potential, the target companies have to be quite stable. So strong, niche, market-leading companies with cost-cutting and expansion potential in non-cyclical industries are favoured targets.

What kind of people work for private equity?

In the UK, there are four kinds of backgrounds:

- Ex-investment bankers
- Ex-strategy consultants
- Ex-Big 4 accountants
- Industry experts such as ex-CEOs or senior managers of corporations.

Many of these people come from Oxbridge/Ivy League universities, often with top MBAs.

What about job prospects and salaries?

Because firms are very small (10 to 20 people on average), there are very few jobs available. Also, requirements are very high due to the high level of responsibility. This makes the industry extremely competitive, even much more than investment banking. Salaries are on par with investment banking, bonuses are usually lower, but you will get the opportunity to share in the profits generated by the fund, which can be substantial.

You can check our [list of London-based PE funds](#)

