# Chapter 23: Equity Types of Private Equity

## Demonstrate knowledge of the relationships between venture capital and leveraged buyouts.

* Recognize the role of venture capital and leveraged buyouts as sources of funding for corporations through their life cycle
* Corporations tend to experience three stages in their lives: a start-up stage, a growth stage, and a stable or mature stage
* Start-up companies: generally have a new or innovative technology, exploited with right amount of capital
* VC relies on new technology or innovation, while buyouts look to see where they can add operating efficiencies or expand product distribution.
* Buyouts take an existing product and refine it through improvements to the production process or by developing new distribution channels or expanding existing ones

## Demonstrate knowledge of the underlying businesses (portfolio companies) of venture capital

* Recognize characteristics of businesses underlying venture capital investment
* The foundation of VC is the underlying start-up businesses and the entrepreneurs who create and build them. Venture capitalists provide financing for these businesses using their own capital and the capital of their investors. Once they invest in a company, they take an active role either in an advisory capacity or as a director on the board of the company
* List the types of securities used in venture capital
* VC usually invest in convertible preferred stock of start-up company, which are favored manner of investment as they are senior to common stock in terms of dividends, voting rights, and liquidation preferences. Plus, VC have option to convert their shares to common stock when exiting via IPO
* Other investment structures include convertible notes or debentures that provide for conversion of principal amount of note or bond into either common or preferred shares at option of VC
* Explain why venture capital investing is similar to purchasing a call option
* The price of the option is the capital that the venture capitalist invests in the start-up company, where gone if failed, but up to very good upside gains, like 20-bagger (20-fold compared to cost of VC investment)
* Def **20-bagger**: company that appreciates in value 20-fold compared to cost of VC investment
* Describe the role of business plans and exit plans in venture capital investment

How does a VC select investments in start-up?

1. **Business** **plan** of entrepreneur, which clearly state business strategy. It has 2 key objectives: 1. To provide information necessary to attract financing from a VC; 2. To serve as an internal game plan for the development of start-up company
2. **Exit plan:** describes how VC can liquidate their investment in start-up company to realize a gain and their investors

## Demonstrate knowledge of venture capital funds

* Define a venture capital fund
* Def **VC** **fund**: PE fund that pools capital of large sophisticated investors to fund new and start-up companies. Each VC fund is managed by a GP, who is typically the VC firm that raised the capital for the fund. The GP sources investment opportunities, review business plans, performs due diligence and takes a seat on board of directors of start-up company
* Recognize how venture capital fund managers raise capital
* Before investing money with start-up ventures, VC fund manager must go through a period of fund-raising with outside investors
* Def **gearing**: increase risk through leverage
* Recognize the terms of the partnership agreement of venture capital funds
* Limit on the amount of private investments the VC fund manager can make on its own in any of the firms funded by VC fund
* Limited in their ability to sell their GP interests in VC fund to a 3rd party
* Restriction on amount of future fund-raising
* GP spend substantially all of the time managing the investments of fund, where outside interests are limited or restricted
* Describe typical venture capital fund fee structures
* **Management** **fee**, ranging from 1% to 3.5%, with most VC funds 3% to 2.5%, based on committed capital, the cash investment promised by an investor. For example, $100MM committed capital with $50 MM invested. The management fee should be based on $100MM
* **Incentive** **fee**:
* Def **capital** **calls**: options for manager to demand that investors contribute additional capital

## Demonstrate knowledge of the dynamics of investing in venture capital

* Describe the stages of the life cycle of venture capital funds and portfolio companies
* Explain the importance of financing stages in distinguishing among various venture capital funds
* Explain the compound option that is embedded in most venture capital investments
* Discuss the concept of the J-curve in the context of a start-up company

## Demonstrate knowledge of the risk and return characteristics of venture capital investments

* Describe the main risks of venture capital investments (i.e., business risk, liquidity risk, and idiosyncratic risk)
* Describe return persistence and vintage-year diversification as keys to successful venture capital investment
* Recognize inferences that can be drawn from comparing definable characteristics of venture capital investments with their historical stand-alone and portfolio performances

## 23.6 Demonstrate knowledge of types of buyout transactions.

* Distinguish leveraged buyouts (LBOs) from traditional investments
* Describe a management buyout (MBO)
* Contrast a management buy-in (MBI) with a buy-in management buyout, and describe the agency issues of buyouts

## Demonstrate knowledge of leveraged buyout (LBO) transactions.

* Describe the structure of LBO funds and the role of various entities involved in LBO transactions
* Describe typical LBO fund fee structures
* Calculate LBO fees
* Describe agency relationships, their associated costs, and their role as a potential source of return to LBO transactions
* Describe general categories of LBO transactions and how they create value
* Discuss the characteristics of portfolio companies of LBO funds
* Explain the appeal of a leveraged buyout to managers and investors of the target firm
* Describe the call-option characteristics embedded in potential payouts of a leveraged buyout
* Apply the constant growth model to the valuation of a leveraged buyout investment
* Describe typical exit strategies of LBOs
* Describe the concept of spillover of corporate governance to the public markets
* Explain auction markets and club deals as alternatives to the single-sourced approach to funding LBO transactions
* Discuss why LBO funds tend to have less risk than venture capital funds