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Talking Financing Options

Understanding Private Equity Financing and Venture Capital for a Business Sale

Private equity financing is investment raised through private offerings or other nonpublic means in order to buy equity in private companies, or in public companies in order to take them private. The most common type of private equity financing is known as venture capital.

Venture capital is money invested at a relatively high risk and potentially high return in a newly formed company or a small company specializing in new technologies. The venture capitalist typically seeks capital gain, rather than interest income or dividend yield. In 2003, some 153 venture capital funds raised $21.4 billion, up from 112 venture capital funds that raised $10.4 billion in 1997. The individual venture capitalist or the venture capital group typically takes a major stake in the high-risk company in return for common stock, often supplemented by common stock warrants, or convertibles. (Common stock warrants are rights to buy the company's common stock at a set price, and convertibles are debentures or preferred stock purchased with an option to convert to common stock.)

Venture capital goes through several stages – from "seed" capital on a trial basis to the "exit" stage when a stake is sold. At each stage, the stake increases. By the time the object of investment goes public (or returns to being a public company), the venture capitalist may own as much as 80 percent of its equity.

The venture capitalist may also help the company obtain debt financing, by helping it seek a commercial bank loan, or by providing the funds itself. When loans are made, the repayment is generally in the form of the right to exercise convertibles or warrants.

As a type of private equity financing, the venture capital investor makes investments in privately held companies (or public companies that are going private). It holds the investment long enough to experience appreciation of share price – usually five years, which has earned it the nickname "patient capital". The big payoff can be when the company goes public. This may mean going public for the first time in an initial public offering (IPO), or it may mean returning to public ownership in a reverse buyout.

Venture capital expects a relatively high return for its investment, because of the riskiness of venture capital investments. Many venture capital funds require a 35 percent return on investment. This high target is set in part because the rate of loss in overall investments is so high – with approximately one-third yielding negative returns. The average return on venture capital investments (taking into account both investments that exceed high targets and those that lose money) has ranged between 12.5 and 24 percent in recent years. The return is often realized when the company receiving the venture capital

money goes public – whether in an initial public offering or, in the case of a company that has gone private using the venture capitalists' money, in a reverse buyout.

Often the terms, venture capital and private equity capital are used interchangeably, but each has its own nuance. The term "venture capital", as mentioned, refers to a significant investment made in a new venture or technology – often by an individual person or entity. The term private equity capital, by contrast, generally refers to funds raised to buy equity via a private offering – that is, an offering that is exempt from registration under the Securities Act of 1933. In fact only one-third of all private equity funds can be considered "venture capital" funds.

Since only 1 percent of all deals purposed to private equity funds succeed, it is important to work with your VR Professional Business Intermediary to decide which funds and individuals should be approached with your investment opportunity.