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Introduction

The seeds of the private equity industry were planted in the 1946 when the American Research and Development Corporation (ARD) decided to form to encourage private sector institutions to help provide funding for soldiers that were returning from World War II. While the ARD had difficulty stimulating any private interest in the enterprise and ended up disbanding, they are significant because this marked the first recognized time in financial history that an enterprise of this type had been formed. In addition, they had an operating philosophy that was to become significant in the development of both private equity and venture capital: they believed that by providing management with skills and funding, they could encourage companies to succeed and in doing so, make a profit themselves (Hsu and Kinney 2004). During the course of their unsuccessful journey, ARD did succeed in raising approximately $7.4 million, and they did have one rousing success; they funded Digital Equipment Corporation (DEC). In the 1980's, FedEx and Apple were able to grow because of private equity or venture funding, as were Cisco, Genentech, Microsoft, Avis, Beatrice Foods, Dr. Pepper, Gibson Greetings, and McCall Patterns.

By the late 1950's the idea of private investment was once again gaining hold; the IRS passed code 1244, which allowed the small private investor who invested $25K in a small business to write off any loss against income. During this time period, there were three main venture capital or private equity companies in operation; the Rockefellers had some investments on their own and others in conjunction with ARD. JH Whitney was established, and Payton and Trask. In 1958, the Small Business Investment Act (SBIA) of 1958 passed, which brought Small Business Investment Companies (SBIC) into existence. The first one was found in 1959; they raised $464 million in their first 13 years of existence (Hsu & Kinney 2004).

Private equity is in fact a very broad term, used to define types of funds or investments. The term signifies the source of the money as opposed to the form which the money takes on. As the name suggests, private equity is private, i.e.: it is not reachable in public markets, such as the stock exchange. One definition of private equity that is in use is "Investing in no-publicly held securities through a negotiated process," (Bance 2004). This definition is fairly descriptive in that it becomes clear that the process is indeed negotiated; the return on the investment varies and the proportion of the company's profits that the investor keeps is arranged between the investor and the firm.

A very hands-on example is having a share in a company that is not listed on the stock exchange. Before Google went public, it still had a lot of investors. Their money was considered private equity until Google's IPO (initial public offering).

It is important to grasp the purpose of private equity in order to understand the difference between private equity and venture capital. Private equity today mostly comes from private equity firms. These firms are not really known, yet hold huge companies and amass fortunes. They are commonly referred to as venture capitalists, although this is not accurate in many cases. Private equity companies buy an undervalued company, change the company, make it more valuable, and then sell it. Upon occasion, the private equity firm will purchase an undervalued firm listed in public offering and take it back to private status while they 'work on it'.

Private equity as it exists today only came into play as a separate entity in the mid 20th century, with development gradually beginning from the core group of private investors mentioned in the late 1950s. Private equity now is mostly used to fund short term deals to buy a company, overhaul it and sell it again. On the modern stock exchange, this is only an option on very liquid markets.

On February 13, 2002, Tim Kelly of GE Capital gave a speech to the graduates of GSB in which he addressed the past, present, and future of private equity. He believes that "consolidation, branding, and differentiation" will begin as the private equity business matures. The business will become more solid as

Enron's fraudulent accounting procedures continue to cause concern in the financial industry and remind investors of potential pitfalls. Kelly believes that the industry will go to a rating system similar to Morningstar, and there will be more scrutiny of programs before funding. He also believes that within ten years, there will be a way for private equity transactions to enter exchange trades (Sharabura 2002).

What is Private Equity?

In the 1980's, financial leverage and buyouts caused a large number of mature firms to go private after IPOs. US public market capitalization decreased from 53.3% down to 29.9%. Further, only 50% of these leveraged buyouts went public again within 7 years (Zingales 1995).

Leveraged buyouts, called "bootstrap" transactions (Rozell 1993), are a way of financing a buyout without investing much of one's own capital. In essence the buyout is financed by the bank; the equity fund uses the loan to buy the company, often using the target company's assets as collateral. The term 'leveraged buy out' was first used by Victor Posner, through his acquisition of the Sharon Steel Corporation (Trehan 2006). This is a very smart form of financing a transaction for many reasons.

In a leveraged buyout, very little capital is needed. In the boom of the 80's the leverage ratio used to be near 100%, but this has since decreased. The high ratio caused huge installments and interest behind it, resulting in high bankruptcy rates. The second and third advantage of leveraged buyouts can be derived from the Modigliani-Miller theorem (Scott 1976). The second is that in terms of return on an investment, the total return on assets (ROA indicator) is not affected by the capital structure. This means that it is not a factor if the company finances itself with shares, stocks, equity, because the return will not be affected. The third advantage is that financing through borrowed money acts as a tax shield. Income through equity is taxed, while interest payments are not. For a company of the size of an equity fund it may be much better to finance through loans because it will not have such high tax obligations (Duffie 1988).

The majority of private equity and private equity based transactions comes from private equity funds. The actual structure of these entities can be disorienting; the fund itself is a pool of capital that companies "throw together" to buy other companies. The funding organization can be a company, a limited partnership, or a limited liability company, with the private equity firm controlling it. Equity funds offer no guarantees; if one invests in a failing company, they are obligated to carry the risk. Investments are very un-liquid; they are long term, with some investment requirements of twelve years. During this time it is very difficult to get access to the money that has been invested.

The advantage to investing in such a fund is that successful funds and fund directors have the means to outperform even the most soaring market. Private equity does not seek out risk to achieve a high profit; indeed, venture capital investments have more associated risk. The difference between venture capital and private equity depends in part on the assignment of risk. Private equity is generally private funding for companies that are established and maturing; venture capital is private funding for companies that are either higher risk or are just establishing themselves. Venture capital is considered a subset of private equity based on the stage of the company, as is mezzanine funding. In mezzanine funding, the firm being funded will be going IPO within 6 months to a year, and there is usually less risk and less potential appreciation than at the startup level, but more risk and more potential appreciation than in an IPO.

Venture capital can be said to be a shifted, changed form of private equity; the strategies in investment are quite different. The main difference between the two terms is only in their strategies. Venture capital pools and companies have exactly the same structure as private equity companies, but because of their target companies and target sectors, they draw a very different type to their investments. People and companies willing to take, and handle risk are the target audience for venture capital fundraising. The dot com boom was initiated with the help of large venture capital companies. Before the boom there were a whole host of small and struggling companies. Venture capitalists saw opportunities which could have led to a financial disaster on their part, but also could have presented them with a golden age (Metrick 2006).

Conclusion

In the final analysis, it is obvious that this type of investment is for the corporate world. Strong companies have a more effective way of dealing with risk, and the initial investment is also very large when talking about private equity. The most active investors into private equity funds, making up 40% of all total investments, were public pension funds, banks, and financial institutions. Other big players in the equity fund market include funds of funds. This is not an unknown term in the financial world. Credit unions have mega organizations, which are credit unions investing in other credit unions. This is done for the sake of risk mineralization. With risk spread out more, the risk any one entity carries decreases. The same rule applies in the equity fund world. In 2006 funds investing in other funds amounted to 14% of all committed investments (Private Equity Intelligence 2006).

Through the years, the private equity field has increased. From the early Rockefeller years to the present, the numbers have increased exponentially. The transmutation of the industry is equally impressive; from the beginnings of the industry to the present. One caution occurs, however. Wingerd (1997) believes that the same phenomena is occurring with the venture capital industry. He recommends placing less money in a position of risk, and more in private equity, in order to ensure survivability in a maturing, but still volatile, industry.

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