

Investing In Private Equity

There has been a great deal in the press recently about 'private equity'. Chris Budd explains what it is, and whether it is worth investing in.

I recently attended a seminar held by an investment firm, who were extolling the virtues of private equity for the small investor. Their argument seemed to make sense on the face of it. Various statistics have been popping up claiming that private equity as an asset class has outperformed public equity (in practice a difficult comparison to make in any meaningful way).

Perhaps more significantly, there is an argument that private equity does not move in the same way as the stock market, and therefore may be an alternative option for people worried about a market correction. And then there are the tax breaks, which have received so much press coverage.

So, what exactly does private equity investment involve, and are there any concerns you should be aware of before investing in a company that makes private equity investments?

Private Equity

Firstly, private equity (PE) is really nothing new. It often involves PE firms borrowing heavily to fund takeovers of listed companies. Once they have a majority stake in the target, they can then de-list it from the stock exchange. Freed from the restraints that go with stock market regulation, they then have a free hand to restructure the company to make it more profitable, and re-sell it back to the stock market at a profit. If all goes well, they can pay back the loan (interest on which has been tax deductible in the meantime, reducing the corporation tax paid, sometimes to nothing), and make a tidy profit in the process.

But what if it doesn't? Well, let's look at it on a smaller scale. If you invest £1,000 of your money in the shares of a company that goes belly up, you lose £1,000. If you've borrowed £1,000 from the bank so you can invest £2,000 and that company goes belly up you've lost £1,000, *and* you owe the bank £1,000 you haven't got. Not a good place to be.

Just like in the early eighties, low interest rates and the cheap money they create have fuelled a liquidity bubble, encouraging this type of 'gearing' (or borrowing to

invest) on an enormous scale. If the markets turn against them, or if a few companies owned by private equity go bust and lose their investors a lot of money, it could all get very messy.

Exposed

Another major concern is that if private investors place large percentages of their money in private equity, as the firm I mentioned at the start were suggesting they should, they may be more exposed to risk than those managing the PE firms.

This is because PE funds have two types of investor. 'Limited partners' (you and me) invest in the PE funds, and 'General partners' manage them. Because of the way they are paid (normally 2% of the invested capital a year plus 20% of any profit), general partners feel the gains a lot more than the losses. This could potentially encourage a high risk mindset which is not in the interests of the limited partners whose money they are investing.

Performance Fee

My other concern is around charges. Because PE bosses take such a large slice of the gains, it has to be funded from somewhere. PE investment trusts, the most likely route in for you or I, will typically charge a performance fee, in addition to an annual management fee (of between 1.5 per cent and 2 per cent of assets). The managers justify these high charges by pointing to their past performance records, which have often been excellent. However, when you consider that even the most bullish PE managers acknowledge that the recent industry boom time is probably over, I have a feeling they will be far more significant a factor going forward.

Having said all that, it's not for me to tell you whether you should or shouldn't put your money in private equity. In fact I like the theory of using it to diversify an investment portfolio so your returns are not so heavily linked to the stock market, and this will no doubt be appropriate for some people. But be aware of the potential risks, and remember the old adage – if something seems too good to be true, it probably is.

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