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Abstract

Private equity investment became an essential component of all variety of alternative investments and is globally recognized as a trustworthy asset class. Following the U.S. colleagues, European investors significantly increased investment in private equity over the past 10 years. Despite the constantly increasing interest in private equity, there is still a lot of investors worldwide, which either have a little to do with this asset class or not dealing with it at all. Neglecting private equity as an asset class takes place largely due to the lack of awareness in this area.

The objective of my work is contributing to consolidation of theoretical background in the field of private equity, as well as understanding of decisions in relation to exit processes, concentrating on private equity investments in European and Russian companies.

Lack of transparency in the private equity industry remains a challenge for many investors as well as for the managers. Though investing in private equity is undoubtedly the most exciting type of investment compared to other assets.

Introduction

Private equity as an asset class plays an important role in the global financial markets and has a tremendous impact on the development of the world economy. Over the last twenty years, private equity funds operated successfully in the U.S. and Europe, and for over ten years in the Russian market. Such processes as the enlargement of the European Union and the creation of an attractive environment for trade and investment contributed to the development of private equity funds. In Russia, driving factors of private equity industry came out from the reduction of restrictions on foreign investment in the 2000s in conjunction with the pre-crisis potential of rapid growth.

In today's economic conditions private equity funds became regular participants in mergers and acquisitions. They finance entries of both public and private business entities in the market and conduct transactions with repurchase leverage. Funds play a crucial role in the sector of venture capital circulation, providing new companies with financial resources and also often providing managerial and operational resources.

The global financial crisis of 2007 led to a global decline in all the markets. The fall of stock markets had a negative impact on the private equity sector. Optimistic mood of investors changed into increased caution, their priorities shifted towards reliable sources of income.

In every investment book it is written that return on investment is always derived from the risk associated with it. Not accidentally private equity investments are also called 'alternative investments'. Their 'alternativity' lies in the fact that there is almost no guarantee of their return and liquidity of such investments is very low. And yet, in my opinion, the main risk of investing in private companies always lies in the plane of human ambitions and passions. No matter how good the strategy or how large the potential of the market is – eventually people will implement the strategy.

Issues of the theory of private equity funds' organization and management gained coverage worldwide in the economic literature. Authors from U.S. and Europe composed a large number of scientific works devoted to the features of organization and functioning of private equity funds. These works have a large field of practical application as they form theoretical basis for the organization of funds and decision-making.

It should be noted, that under the existing methodological research of the importance of the problem the theoretical background has not been fully formed, and most of the research and publications concern the narrowly specific parts of the investment process. There are still many unresolved issues related to the functioning of private equity sector associated with asset management strategies to modern economic realities.

The objective of my work is to contribute to consolidation of theoretical background in the field of private equity, as well as understanding of decisions in relation to exit processes, concentrating on private equity investments in European and Russian companies. Due to the fact, that the access information regarding private equity firms' is substantially limited, my work is going to analyze theoretical aspects of the entire private equity investment process, motivation of choosing the divestment route for the company, as well as focus on the functioning of the private equity market at the moment globally and in relation to Europe and Russian Federation. I am going to emphasize the existing problems in the industry as well as the perspectives for further development of the industry.

In the first chapter I define the notion of private equity investment, justify what is the theoretical background for it, what are the private equity funds, how they function and how their performance is measured.

In the second chapter I emphasize the options to 'exit' portfolio companies and the motivation for these choices, as well as present the concept of the initial public offering (IPO) as the most desirable 'exit' method.

In the third and fourth chapter I analyze the performance of private-equity backed IPO's and compare it in Europe and Russian Federation; I emphasize existing problems in this sector and propose certain ways to diminish them, as well as align perspectives of the development in the future.

European venture investments continue being 'endangered species', a victim of investors' prejudice. Equity investments in private companies continue to be ignored by the investors, the brightest example - governmental pension funds. The fact that such attitudes still prevail in some circles indicates lack of knowledge about private equity investment. For instance, some investors continue to believe investments in private equity and a buyout of a big company is the same thing. A number of investors do not distinguish PE funds and hedge funds, which increases confusion. Lack of transparency of funds

remains a challenge for many managers who don't publish information about their holdings. Investing in private companies is a much more complex phenomenon than even a decade ago, but it is undoubtedly the most exciting type of investment compared to other asset classes.

1. Private equity as an asset class.

The notion of ‘private equity’ refers to investing in equity or associated with share capital in companies whose shares are not listed on the stock exchange. A capital supplier acquires equity ownership stake in a company (which gives the right of control over the company) and helps with the development of business with the intention of value increase in a long-term prospect. Thus, private equity is a very “entrepreneurial” type of financing often providing companies not financed by banks with capital. Moreover, private equity investment funds often function as an ‘active owner’ helping in formulating strategy, as well as in practical activities, being a critic and an advisor, on which opinion company’s management team can rely. This is especially important for the young companies, but also valuable for more mature companies, which are confronted with difficult strategic issues.

Private equity investment can be used for the development of new products and technologies for a working capital increase, for implementing acquisitions (mergers) or stabilizing the balance sheet. When a company is young and capital is spent on the development of business, such financing is called – ‘early stage’ investment. Early stage financing is usually referred to as venture capital, which is basically a subset of private equity. When the business is already more mature, it is invested in capital growth or expansion required for the subsequent development of the company in terms of increasing its productivity, expanding markets and geography. From this point I am going to use the term ‘private equity’ covering both venture capital and private equity investments.

Through in private equity investments it is also possible to address ownership and control issues resulting in particular in cases of business buyouts by experienced internal or external management teams (MBI or MBO respectively).¹ For example, private equity investment will help address issues of property inheritance within the family business. In case of MBO or MBI senior debt or mezzanine financing can be partly used for funding, while their levels depend on the economic conditions in general.

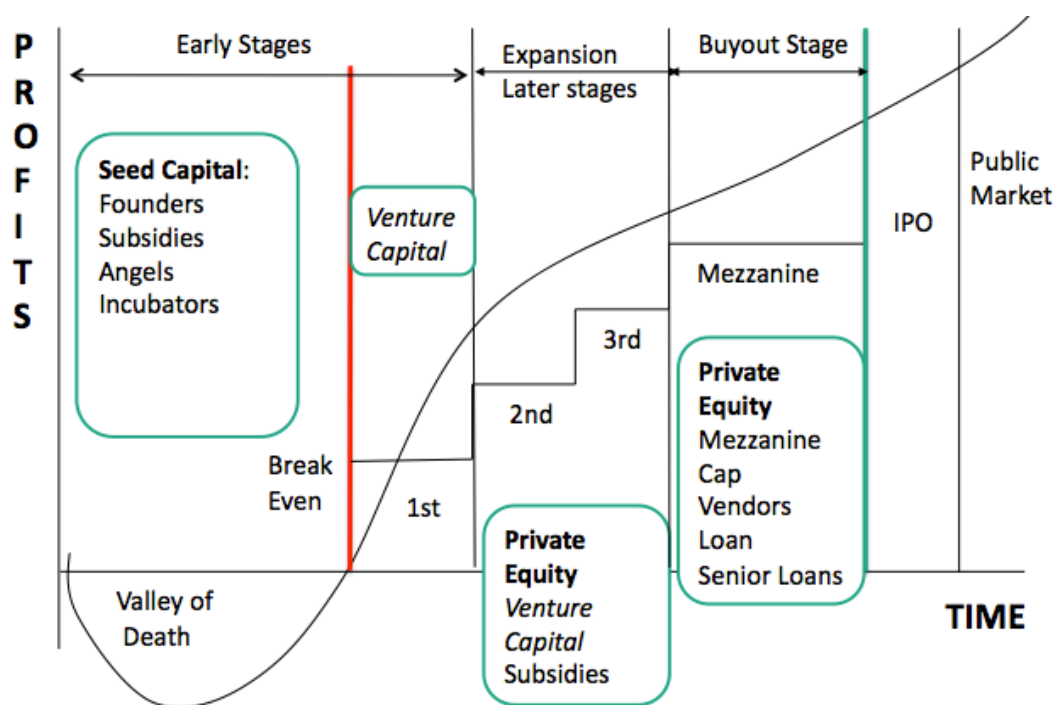
In most cases private equity investment is granted for a limited period of time. A business, which entered the next stage of its development can be purchased by its managing team or sold to the interested external customer (such as strategic buyer or other financial investor) or may place shares on the stock exchange (IPO). Some PE funds can

¹ See Fraser-Sampson, 2010, p.115

hold investments indefinitely and in such cases there is no need to organize the exit of investment.

In addition to the above mentioned the most frequently encountered types of private equity investment, allocated in accordance with the age of the company and the aim of financing, there exist some later appeared investment segments which focus on ‘special situations’. These investments are initiated by particular situations in which a company may be involved.

Figure 1. Business stages and corresponding capital



Source: Adapted from Cumming/Johann (2009)

There exist four general types of investment in private equity: buyout, development capital, growth capital and venture investments. The best way to review these investment types is from a position of a life cycle of a company. This basic instrument of business analysis suits well for highlighting its special sphere for each of the four activities in the field of private equity investment. It is also important to remember that the generated cash flow should continue to increase while moving along the coordinate axes to the right.²

When the company is in the *start-up stage*, it lacks money supply, because the product is still in the development phase. In course of time company enters the *growth*

² See Fraser-Sampson, 2010, p.19

stage, which allows generating income. However, taking into account the significance of the cost for promoting goods in the market, total cash flow will have negative value. Only after reaching '*maturity stage*' company begins to make profit and cash flow becomes positive.

The most significant cash inflows are observed on the stage of '*downturn*', what can sound contradictory at first, but to this point less successful competitors are forced to leave the market.³

Venture investments are focused on the start-up stage of the life cycle. Companies, which are supported by the venture capital are on the relatively early stages of the development, sometimes also on the stage of an idea.

Growth capital is not unexpectedly used on the *growth stage* of the life cycle. The company on this stage is characterized by the need in the rapid increase of sales for maintaining its market share in the rapidly growing markets. Buyout capital is more targeted on the last two stages of the life cycle.

One of the most important PE industry events occurred over the last decade is the development of the secondary market for shares, attracting and retaining a growing number of customers, whose experience grows constantly. Remaining still an illiquid asset class, private equity today provides investors with access to different categories of investment not only on the primary basis.

Private equity is an important resource for companies at various stages of their development, providing not only capital but also managerial and industrial experience; it allows financed company strengthen its competitive position, continue the grow and acquire value not only for a private equity fund and for investors but also for the economy.

1.1. History of private equity

The definition of 'private equity' gained widespread coverage in the late 1980s, following the growth of public interest in the activity of LBO funds, especially in the U.S. In fact, the development of private equity markets happened much earlier and can be attributed to the period of the formation of such groups as Charterhouse Development

³ See Fraser-Sampson, 2010, p.20

Capital in 1934 and “3i” in 1945 in Europe and the American Research and Development Corporation in 1946 in the U.S.⁴

Investment group “3i” was initially called Industrial and Commercial Financial Corporation and was founded by the clearing banks of the United Kingdom to meet capital needs of small businesses and was mostly engaged in providing long-term capital needed for development. On the contrary, ARD wanted to commercialize some new technologies, which were developed during the war by fundraising using institutional capital with the help of closed-end investment company. Both new funds used their own industry experience for the valuation of the companies, which made them different from the traditional ways of concentrating on guarantees. However private equity market in general remained fragmented for some time, it was dominated by venture capital investments in individual companies on the early stages of their development (business angels) and to the smaller extent – investments within the confines of government programs and various non-profit foundations. Among the most well known companies receiving early stage venture capital investments were the Digital Equipment Corporation, Federal Express and Apple Computer.

The main impulse for the development of private equity industry both in Europe and in the U.S. in 1970s was the following: in 1971 United Kingdom introduced measures of competition and loans control which gave more freedom to banks for implementing investments. Following this, structural and legal changes took place in Europe, for example in the rules of pension funds and insurance companies, which contributed to the liberalization of the investment choice opportunities for institutional organizations. Changes in operating assets from investments with fixed yield to equity and other products have accelerated in the late 1990s due to the low level of inflation at that time. This environment gave rise to the value of the special skill of successful private equity investors to create conditions for the growth of portfolio companies and get income for investors (LPs).⁵

In the early 1990s the industry has embarked on the path of rapid growth internationally, reaching its culmination in 2000 when private equity funds generated over 200 billion EUR worldwide. More than half of that sum was invested in the venture capital segment, which was waiting for the ‘new economy’ to come – where Internet and creating

⁴ See Boue/Kehlbeck/Leonhartsberger-Heilig, 2012, p.16

⁵ RVCA, “European approach to Private Equity investment”, 2011, p.10

networking businesses would have to overcome the dominance of traditional business models with their limitations. The growing involvement of private and public LPs in the increasing number of international capital markets also contributed to this development. During the “dot-com bubble” in 2000 the level of venture capital investment in Europe has surpassed the level of buyouts reaching the volume of EUR 20 bln. investments. Venture capital investments – especially in the early stage companies – have become widely known, which raised the level of awareness about this asset class. Increase in market volume and subsequent exit of the market of some LPs after the ‘bubble burst’ contributed to the growth and creation of the secondary market, where the shares of contribution into private equity funds are traded among partners with limited liability.⁶

Following the ‘bubble burst’ in 2001 and under the impact of subsequent economic slowdown, the segment of buyouts came to the forefront, which in 2002 outperformed the venture capital segment. In 2004 private equity investment activity rose again mainly due to buyout sector, which corresponded 70% of the European market investments. On the background of strong economic growth, low interest rates and unprecedented market liquidity buybacks experienced a period of recovery with constantly enlarging transactions. At this highest point of the market American investment company KKR acquired Alliance Boots (part of the FTSE100) for EUR 14.1 bln., which until that time was the biggest deal in Europe. Beginning from the 2nd half of 2007 deterioration in the credit market due to the global financial crisis affected the amount of available credits required to complete LBO. As a result – investment activity has declined substantially. (*Appendix 1*)

1.2.Theoretical background

Scientific coverage of various aspects and stages of private equity investment has emerged over the past decade. Few examples of the recent contributions are in the works of Gompers and Lerner (1999, 2003), Ljungquist (1999), Lee and Wahal (2002) focus on the role private equity investors in the going public process, Gompers et. al. reviewed the existing knowledge in the field of listings of portfolio companies⁷, MacIntosh in his work of 2003 discussed factors, which affect the choice of the divestment route from the investment.

⁶ See Boue/Kehlbeck/Leonhartsberger-Heilig, 2012, p.18

⁷ See Gompers, Lerner, 2003, p. 2-5

Lerner and Gompers in their work of 2004 focus on the divestment aspect of investments in private equity, which happened to attract limited scientific attention so far, as well as they stress that the topic of motivation to exit portfolio investment is not supported by a number of theories.⁸

Nevertheless, there exist a number of theories, which contributed to understanding of the entire private equity investment process and related aspects, together with the choosing of the exit route, which is relevant for this work.

Phenomenon of information asymmetry between private equity investors and managers of a portfolio company is a subject to the agency theory (*Figure 2*). In 2004 Kaplan and Stromberg point out in their work that agency problems are very important to the contract design, which governs the relationship between private equity investor and entrepreneur.⁹ Theory is also relevant for understanding of private equity investors' divestment behavior.¹⁰

According to Spreman (1990) there are three basic types of asymmetric information causing agency problems, which can be classified as follows:

1. *Moral hazard* – arises when it comes to acting to the disadvantage of the principal and these actions are evaluated differently due to the opportunistic behavior.

So, these are circumstances, when the agent can either undertake a hidden action, which is not observable by the principle (post-contract opportunism) or can use information unobservable to the principle to increase his utility.¹¹

2. *Holdup* – situation in relation to the behavior of the agent in the agent-principal relationship, when the agent fails to meet contractually required agreements because of unfair actions. So, the agent uses deficiencies in the incomplete contracts in his favor and after certain actions have been made – reveals previously hidden intentions.

3. *Adverse selection* – a negative consequence of asymmetrically distributed information between two parties, where one party has hidden characteristics and another one does not have access to the qualitative information about the party. It refers to the lemon's market problem worked out by Akerlof, who presented in 1970 an example of the U.S. used cars market. Phenomenon relies on the situation when the price will only be paid

⁸ See Gompers, Lerner, 2004, p.2-16

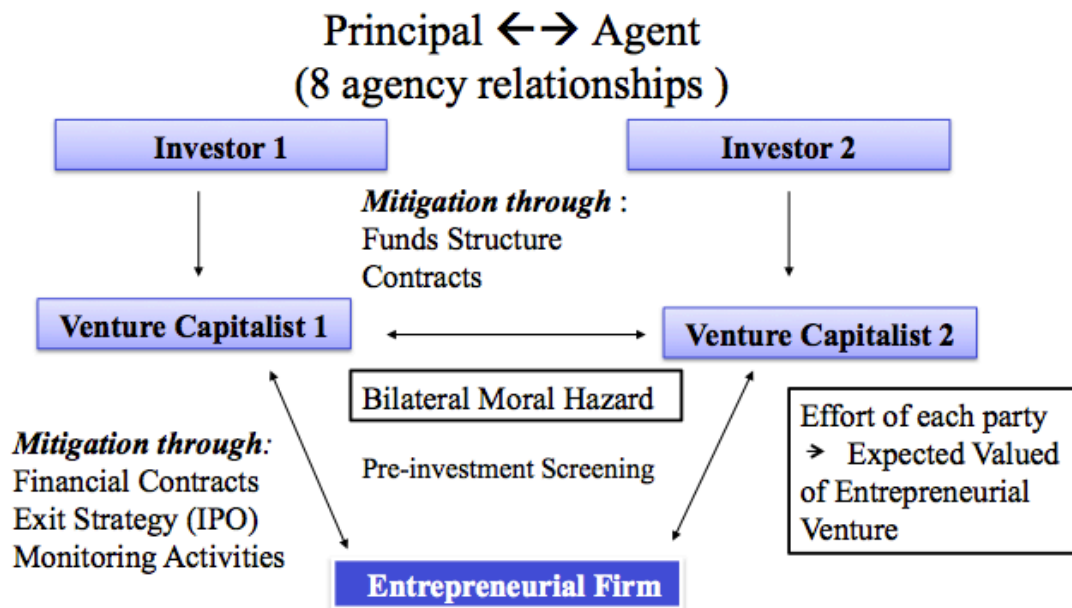
⁹ See Povaly, 2007, p. 113

¹⁰ See Kaplan, Stroemberg, 2004, p. 2177-2210

¹¹ See Spremann, 1990, p. 561-586

oriented on the average quality investment because of uncertainty of the quality of investment, so the providers of more profitable projects stay away of the market: in this case the company looking for investment is the agent, having information advantage, and the investor is the principal.¹²

Figure 2. Principal-Agent Problem.



Source: adapted from Gompers/Lerner(2001); Cumming/Johan(2009); Kaplan/Strömberg(2000); Gompers(1996)

From a value maximization standpoint Cumming and Macintosh argue that under circumstances of high information asymmetry rank ordering of preferred exit vehicles would be as follows: IPO's and acquisitions secondary buyouts, buybacks and trade sales.¹³

¹² See Povaly, 2007, p. 113

¹³ See Cumming, Douglas et al., 2003, p. 511-548

1.3. Brief overview of Private Equity legislative framework

Analyzing foreign legislative regulation experience of private equity industry allows concluding, that in most developed countries there exists no special law in the field of private equity investment. Such investment method is carried out in the framework of the regulation of legislative activity.

Special laws governing private equity and venture capital activities were only adopted in Hungary and India; there is also a bill under development in China. The most developed model of legal regulation at the moment exists in the USA.

Neither in Germany, nor in Austria exists an independent private equity regulating law. This situation is being criticized by the industry associations (BVK in Germany, AVCO in Austria). The economy creates necessary structures for the provision of off-exchange equity and for using profit opportunities regardless of the existence of specific laws. Though it is not clear if these framework conditions support or hamper the private equity industry.

In Austria there exist different legal bases governing capital markets: Bankwesengesetz (BWG), Wertpapieraufsichtsgesetz und Investmentfondsgesetz; which regulate capital markets, but only indirectly – private equity industry. Körperschaftsteuergesetz (§6b) severely restricts investment opportunities, where only certain target companies (SMEs not traded on a stock exchange) are approved and also the reasons for funding are restricted.¹⁴ So, the law allows SME financing companies to provide starting and expansion financing in the first line if they want to keep tax privileges. Other financing occasions such as turnaround financing or buyouts, which present a big part of Austrian financial reality, are not foreseen.¹⁵

In Russian Federation there are no specific regulations about private equity activities. However, due to the fact that private equity investments belong to investment activities, it is not possible to talk about the lack of legal regulation in this field. The main legislative basis for regulation of private equity investments in Russia is the Federal Law of 25 February 1999 ‘On investment activities of Russian Federation, implemented in form of capital investments’.¹⁶

¹⁴ See Boue/Kehlbeck/Leonhartsberger-Heilig, 2012, p.57

¹⁵ See Boue/Kehlbeck/Leonhartsberger-Heilig, 2012, p.58

¹⁶ RVCA, “European approach to Private Equity investment”, 2011, p.14

Regulatory and tax environment in Europe different in each European country makes it difficult to create a unified fund structure, which could be effective for other investors. It is often necessary to create two or more funds with different structure or legal address to allow LPs from different countries to co-invest for the composition of common portfolio.

Regarding the tax status of investors the most important thing is that there are no additional tax charges at the fund level and the investor is not obliged to pay the tax again in another country. Despite the fact that the structure of a fund is based on the principles of transparency, these structures may not always be recognized as transparent by other jurisdictions, so sometimes it is not possible to avoid taxation of the establishment (permanent establishment) in the territory of the other country. A common structure, used in Europe, is a limited partnership, but there are also several other fund structures, which meet the criteria of transparency and limited liability.

1.4. Advantages and disadvantages of Private Equity

Why investing in private equity? The main justification for a private equity investment is the afforded opportunity to improve the risk and return characteristics of the investment portfolio. Private equity investments give a chance to partners with limited liability to make a significant contribution to the income of portfolio.

Potential of the long-term effective work

Distinctive features of such asset class as private equity complicate direct comparison of private and public markets' performance. An important difference between PE investment and buying shares in a public market is the fact, that while the investor can start the closest possible contact with a stock exchange passively buying shares at a given rate, there exists no alternative for a direct investment. Another difference is the highest spread in the amount of income from PE investment. If investment managers in public markets typically create income, which doesn't diverge too much from the market index, PE managers, which do not have any index to revise, create portfolios showing completely different results. Hence, in a situation of direct investment - active management and selection skills are very important – the skill to determine which private equity managers can produce above-average income is the basis of effectiveness for every investor.

Correctly selected assets for an investment give a potential of substantial increase in the income of portfolio.¹⁷

To fully reveal the potential of PE investment, there is a need in a system of gradual capital inflows to the fund during a long period of time (commitment). In the past, experienced investors could create portfolios of private equity assets, which showed to be more efficient than public markets and other asset classes. Long-term investors showed to be most effective among those investors realizing the full potential of this asset class.

Diversification of portfolios

Value of a PE investment as an asset class consists in the opportunity of portfolio diversification. Although it is quite difficult to accurately measure it, the correlation of PE assets with other asset classes is limited. Furthermore, direct investment is one of the few investment instruments that have long-term potential to create value, which makes it very important for institutional investors with long-term structure of their obligations.

Furthermore, addition of new subclasses of PE investments, such as counter-cyclical distressed debt or turnaround investment, helps LPs to further diversify their portfolios, focusing on economic and financial cycles.

Finally, the development of global private equity markets in the U.S. and Europe and then in developing regions, such as Asia, Central and Eastern Europe or South America – allows LPs to diversify their direct investments also by regions, thus having a chance to take advantage of various economic cycles and markets of different maturity.¹⁸

Ability to benefit from the shift of economic cycles

Long-term horizons of PE investment give the possibility to benefit from the opportunities coming from the change of economic cycles. Historical data on investment efficiency show that the investment implemented during or immediately after a period of economic downturn came out to be the most productive.

¹⁷ See Cumming, 2012, p.65

¹⁸ See Fraser-Sampson, 2010, p.51

Characteristics of PE investment

1. Control over investment

Typically a PE fund takes a certain degree of control over portfolio company which allows it to exert influence on its strategy to make changes in the composition of the managing team in case of ineffective work, improve manufacturing processes, bring new customers and make every effort to ensure that sometimes too ambiguous business plan was implemented.

Although in some cases investments are syndicated as a result of the fractional capital structure, the fund is interested in taking timely decisions, providing maximum influence on the company's value. Therefore, a business model of private equity investment provides company with a possibility of getting something more than just capital.

2. Alignment of interests

Interests of fund managers in a PE fund are largely consistent with the interests of their limited partners, as managers invest in each fund a substantial share of their equity. That is why they are interested in that each investment is carefully prepared and to create value, delivered after the investment period. In addition, PE funds report quarterly to their LPs on the status of individual investment that allows investors to monitor the portfolio from a 'short distance'.

There is also reconciliation of interests between the managers of the fund and those of the portfolio companies. Mostly, managers of a portfolio company invest their own capital in company and thus participate in the creation of value. Continuing existing performance reporting between a portfolio company and a PE fund, as well as active participation in the board of directors – contribute to the strengthening of the managing standards in companies.

This leads to a common understanding that private equity investments and similar models are more successful public company's models, in which numerous anonymous shareholders with different objectives and business profiles have no influence on their investment. PE investment contrasts with today's orientation on short and quarterly efficiency, focusing efforts on a long-term perspective and ownership structure, which corresponds well to periodically taken long-term strategic decisions, based on sufficient

information. Thus, another important advantage of PE investment in equity is that the control and impact from short range reduce risk, inherent to public investment.

3. Selection of companies with high potential

One of the main skills of successful PE managers is the ability to select companies and industries with high growth potential and actively stimulate growth conditions for them. Since PE funds are used to have large and often controlling shares in the companies, these investments tend to belong exclusively to one fund, and LPs of such funds get exceptional benefits from the created value. This confirms the fact that the only goal of the company is value creation and achieving of planned milestones in its development.

2. Private equity funds

2.1. Structure of a fund

In many respects, investments in private companies are substantially different from other asset classes. One of the most significant differences is how private equity funds function.

Private equity funds are funds, which are financing closed companies, not traded on a public market, which operate in two segments: segment of venture investments and segment of direct investments. They help their portfolio companies overcome a distance from a small venture firm to a big publicly traded company through financial investment, participation in management of the company, raising debt financing on favorable terms, rebuilding of internal processes. Private equity funds offer higher potential return, but at the same time they are exposed to a high level of risk, typical for private equity investment (includes such risks as liquidity risk and price risk). Private equity fund makes profit through the exit from the portfolio of the company. The most effective exit tends to be – selling shares on the stock exchange during the IPO, as well as other ways to reach exit.

Private equity funds always have legal form of limited liability partnerships, as a result investors in such funds are called ‘limited partners’ (LPs) and managers of the funds are called ‘general partners’ (GPs).¹⁹

The basic idea of a limited liability partnership is following: there can exist any number of passive investors, who don’t play active role in business and having limited liability (in terms of the reserved capital), but there should be at least one general partner, who takes necessary decisions and manages the business directly.

Limited liability partnership is a closed-end fund with a fixed period of existence (usually 10 or 12 years, depending if the fund is engaged in buyouts or venture investments, in both cases there exists right of double extension). Funds with a fixed term of existence are widely spread in the U.S. and the U.K., where limited partnership has long been considered a common form of business. In the continental Europe investment in private equity was largely carried out as open-end structures.

Establishing of a company since creation of some idea to turning it into a publicly traded large company can take many years. Yet, during the growth, and thereafter it retains

¹⁹ See Fraser-Sampson, 2010, p.35

the same need – need for financing. Private equity funds designed to meet some of these needs occupy their own special niche. When a start-up appears it is financed by an entrepreneur or by a team of entrepreneurs. At this point the company has no assets or credit history and the debt capital is explicitly unavailable. Usually, if a company receives a loan, then it is a kind of loan where the founders guarantee for it personally, providing personal assets as a deposit. Therefore to a certain point of time the company receives money from its founders.²⁰

If a company has perspectives, soon it will need money will soon exceed the capabilities of founders. In the first round of funding there are usually ‘business angels’ on the stage. Business angels are usually wealthy people willing to invest a part of their savings in a risky, but from their point of view promising, enterprise. Many of them are successful entrepreneurs or business owners themselves who either still have such kind of business or have already sold it and now support the newcomers by their participation.

Table 1. Characteristics of Funds providers

Typical Characteristics of Some Funds Providers						
Source	Investment Motivation	Focus of Attention	Cash Typically Available	Source of Funds	Biggest Drawbacks	Biggest Advantages
Private ‘Angel’ Investors	The Entrepreneur	Varies	\$500,000 to \$1.5M	Previous Successes	Varying Commitment	Brings Credibility
Venture Capital Funds	Business Plan, Team, Market, Development	Contracts, Valuation	\$1M to \$20M	Limited Partners, Institutions	Time Consuming, Expensive	VCs monitoring, Innovation
Private Equity Funds	Mezzanine, Buyout, Turnaround	Contracts, Valuation	\$20M to \$500M	Limited Partners, Institutions	Time Consuming, Expensive	Brings Help, Credibility, Increase Innovation

Source: adapted from Cumming/Johann (2009)

Besides providing money ‘business angels’ are helpful in many other aspects. As investors they have a vested interest in the success of the company, so they use their own entrepreneurial experience and connections to help companies. For example they can provide an entrepreneur with necessary business contacts to help get a contract or simply

²⁰ Fenn, Liang, Prowse, 1995, p.15

advice what to do in a particular situation. ‘Angels’ never buy a controlling stake in the company preferring to remain minority investors.

Internationally the most common organizational form for a private equity fund is limited partnership. The scheme of such fund’s work and the investing principle is similar to venture funds. Typically, the structure of such fund looks as follows:

1. Company specialized in management of venture capital funds creates a new fund. The fund is organized as a partnership with limited liability (limited liability partnership). Fund itself is just a legal formation. The real work is going to be done by a managing company.
2. Investors (limited partners) of the fund are usually individuals, corporations or pension funds. Their contributions are made as a percentage of partners with limited liability. Often investors do not contribute their shares in cash, but in commitments – promise to invest a certain amount at a time when the amount is needed. Here, however, exists a risk that at the time when the required amount would be really needed investor will change his mind (though ‘changing mind’ is usually subject to penalties).²¹

Venture company also usually contributes some money and becomes the managing company (general partner).

2.2. Performance of PE funds

As already mentioned before private equity investments differ substantially from almost any other asset class. That is why it is impossible to use periodical yield (especially annual yield) on the basis of which most investors evaluate other asset classes, in the evaluation of private equity investments performance.

The main challenge in understanding private equity investment as an asset class consists in assimilation of the fact, that annual rate of return is irrelevant to the evaluation of the fund performance results. For a reliable assessment of the fund performance it is necessary to consider the cumulative profitability of its previous cash flows. This is a moment to use internal rate of return (IRR).²²

²¹ See Grünbichler, Graf, Gruber, 2001, p.261

²² See Cumming, 2012, p. 353

As I mentioned earlier there exists difference between investing in a PE fund and funds, which invests in the shares of publicly traded companies. Analyzing this difference precisely from the perspective of financial mathematics: *first*, time plays a significant role: private equity funds raise and invest capital, which is consumed by a portfolio company during several years, while in a public fund the raised capital can be used immediately. *Second*, the graph of private equity fund profit presents typically a J-shaped curve – losses turn into profits only by exiting a portfolio company. In addition, due to the fact that there exists no secondary market for private equity investment, it is quite difficult to value them.

Before investing in PE funds investors generally carry out a comprehensive review (due diligence), having to verify that the fund has a steady income and the revenue information was not distorted in the past. After investing money in the fund investor is being informed about the results of his investment. There are no public quotes but there is a set of indexes relying on which junior fund partners can draw conclusions about the future profits.

Investors pay strong attentions to the following indicators:

- Net asset value (NAV);
- Internal rate of return;
- Performance of the GIPS standards.

Private equity funds must report regularly to the investors, and NAV is the most descriptive indicator for this. It represents *total assets of the fund minus total liabilities*. Usually the senior partner estimates NAV of the fund. Junior partners use hired consultants for the same purpose.²³

To evaluate assets, management of the company can use one of the 5 methods:

1. At the cost of acquisition, with subsequent addition of the cost of financing;
2. At the minimal market cost;
3. By the constant reassessment of assets, every time when the new portfolio company is bought;
4. Only at the acquisition cost, without any revaluations until the divestment;
5. Less often by applying discounts for lack of liquidity to the cost of the securities of similar public companies traded on the securities market.

²³ See Fraser-Sampson, 2010, p.271

It should be noted that there exists no exact method, since the market value of portfolio companies is not defined until the exit. For funds with different existence duration and with different strategies it is necessary to use different methodologies. Funds, which are close to their termination use comparisons with peers to assess portfolio companies. Newly created funds usually use acquisition cost.

Furthermore commitments of junior partners, not used by the managing company, are not included in the calculation of NAV, but are a kind of asset of a fund, which can be used in the future. To assess the value of these commitments, it is necessary to know the money stream generated by the investors of the fund, which practically is difficult to predict. And any problems with the collection of funds arising from the senior partner imply its low cost.

Thus, the *disadvantage* of the NAV indicator is lack of a standard approach to the assessment, inability to reflect differences between funds on the timing and nature of investment, inability to reflect certain types of assets.

Internal rate of return - IRR

IRR is the internal rate of return, recommended by international standards to compare funds activities. IRR is calculated based on cash flow. Disadvantages of the IRR indicator is the suggestion that the cash flows, received before the exit from the portfolio company are reinvested at the same rate, as in practice they cannot be reinvested (as investments are illiquid). Despite this, IRR is one of the most important indicators of the funds performance, which should be paid much attention.²⁴

It is distinguished between gross and net IRR. Gross IRR reflects the ability of the fund to generate income from portfolio companies and is a measure of cash flow between portfolio companies and funds. Net IRR differs from gross IRR through the amount of payments to the managing company, percentage of earnings and other payments to the senior partners. Net IRR is a measure of cash flow between the fund and junior partners.

²⁴ See Fraser-Sampson, 2010, p.271

IRR is calculated as follows:

$$0 = \sum_{i=0}^n \frac{CF_i}{(1+r)^i} + \frac{RV_n}{(1+r)^n}$$

where CF_i is the cash flow generated in the period i .

Annual yield is recognized as a common measure of performance, but at the same time a completely different approach to the evaluation of return in investment is gaining strength. Funds of investments in private companies can be seen as a series of individual cash flows, to assess which it is best to use internal rate of return. This measure has a real drawback. Though leaving aside that part of listed capital that goes to reward the management team and to cover other expenses of the fund, IRR shows the yield on money invested in the project, but the period during which money is tied up there is not considered. IRR is the accumulated indicator of profitability, which means that for IRR not to change, yield itself should increase annually. Multiples are used for the more adequate assessment.

GIPS indicators

The most commonly used indicators, selected by the GIPS standards are following:

- ➔ PIC (paid-in-capital). The indicator presents a share of fund capital, already invested at the current moment (can be both absolute and relative);
- ➔ DPI (distributed paid-in capital). The DPI puts the sum of all incomings of payments in relation to all outgoings of payments.
- ➔ RPVI (residual value to paid-in capital). Index calculated foregone potential investors' income and presents the funds of the Junior partners in the current funds capital, divided by the originally invested capital;
- ➔ TVPI (total value to paid-in capital). Reflects the received and not received income of Junior Partners and is the sum of DPI and RVPI.²⁵

²⁵ See Cumming, 2012, p. 354

Great importance in the evaluation of the fund's performance has also a number of other indicators. Investors of the fund often use these indicators because of their simplicity and possibility of separating the received and missed income.

In addition to the quantitative analysis based on multiples, NAV and IRR, investor should also conduct qualitative analysis, containing the following:

- Implemented projects and investment of the fund in order to correlate the amount of successes and failures;
- Potential of the current investments with evaluation of the exit horizon and possible financial problems;
- Cash flow forecast of portfolio companies.

Private equity funds differ strongly from each other, so before making an assessment of the fund performance, investor should have a good understanding of the structure of the fund, terms, evaluation methods, results of the due diligence. Net IRR of the fund must be calculated together with the meaningfully value-equal fund group with the same term of existence and strategy.

3. Divestments of portfolio companies

Exit procedure in the investment life cycle is central for the activities related to investments in private equity. One of the main characteristics, which can distinguish a private equity investor from other types of investors, is planning exit at the stage of making initial decision of investment. Generally, the time interval between investment and divestment is from three to five years on average, depending on the market conditions. During this period private equity investor participates in the process of company's value increasing. Logic of private equity investment process implies that by the time when the company will be prepared to exit, its value increases so that it will generate relatively high income typical for PE investment. The purpose of this chapter is to understand the nature of exits, focusing mostly on an IPO exit route.

3.1. Comparative characteristics of exit options

Until the mid-1990s the vast majority of successful exits in Europe was preformed through direct sale, as only mature companies had access to traditional open markets. In 1996 the situation began to change with the creation of local European stock exchanges designed for young growing enterprises. Ability to place shares on such stock exchanges as NASDAQ, Nouveau Marche, AIM and Neuer Markt, made IPO a viable alternative to direct sale as another tool to realize the cost of investment.²⁶

Existing various opportunities for exit constantly relate to economic conditions and market interest in certain industry segments. Although it is very important for an investor to develop an exit strategy in advance, he must be prepared to show flexibility and adaptivity, when the exit moment is approaching. Investors also need to recognize when the adverse cyclical conditions of the market, where he was planning to make exit, send out a signal to better choose another method. Ability to understand what is happening on the market and anticipate the onset of certain cyclical changes is a key skill of an investor.

Private equity fund makes profit from a difference between the buying price of a portfolio company and its selling price. As mentioned earlier, private equity investment involves buying shares of closed and illiquid companies, that is why turning them into liquid capital at the moment of the expiry of investment becomes a kind of art. This

²⁶ RVCA, "European approach to Private Equity investment", 2011, p.25

process is defined by 'exit'. There exists a number of ways to exit a portfolio company and each one is unique. If we were ranking, we can distinguish several basic methods of turning investment into cash:

1. IPO
2. Selling of the company to the strategic buyer or selling of shares to the financial buyer,
3. LBO
4. Reorganization
5. Liquidation

1. **Initial public offering or IPO.** First method to convert investment into cash is to put shares into the public market. On the stock exchange it is more feasible to get real money for the company than everywhere else, that's why IPO is a goal for every investor. However, first public placement is a quite expensive and complicated process, which requires company to meet standards of transparency, profitability, etc.

In addition, company's shares can be put on sale by many investment banks and stock exchanges of the world, but only some of them are specialized on sale of small and developing companies. As for banks, almost every investment bank has its own criteria for putting company's shares for sale. For example, large national banks will not put up for sale company's shares if the demand for them is too small in terms of sums or the scale of their business. Though small broker-dealer firms may have insufficiently qualified staff. Negotiations with underwriters are always carried about the company's profits for past periods and expected profit in the nearest years. If a company meets three basic criteria – rapid growth, presence of the profit bigger than in the industry on average, corresponding to the minimum standards of the stock exchange, it becomes a likely candidate for the nomination of shares for sale. Nevertheless the number of shares, which can be sold during the IPO, is defined by the intermediaries-underwriters.²⁷

2. If the process of public offering seems to be too complicated and the implementation is unlikely, it is possible to proceed with another exit method – **sale of the entire company to a strategic buyer.** In the world there are companies of open and closed type, who see the way of their own growth in acquiring other enterprises. Sometimes these

²⁷ See Cumming, 2012, p.446

companies buy an enterprise in the same industry, and sometimes the buyer is looking for a way to enter a different industry. Sale to a strategic buyer is valuable because the buyer will pay more for the company, as he will buy the controlling stake and not the part. In addition, there are financial buyers who can pay for a portfolio company almost as much as a strategic buyer. Financial buyers are funds involved in buying the controlling stake using a loan, and other associations, who are looking for the opportunities of profitable investment.²⁸

3. **MBO – Management buyout.** Another method is the buyout of the portfolio company shares by the owners of the company (management buyout). Such tactic is rarely used and is called – change of capital structure. For such scheme to take place, it is necessary that the management of the company has enough funds, or could borrow money from a bank or an investment company. After the share buyback entrepreneur and all shareholders will own 100% of shares, but herewith the company increases its debt obligations.

4. Another method is a company's **reorganization** (this term has a synonym – bankruptcy). Many small companies get rid of creditors and investors through reorganization. This is one of the worst situations for the fund, because in this case the fate of investment is in the hands of a court. And a court is not a place for debt collection, except if you are a lender, but even then the procedure can cost a large amount of money.

5. The last method is **liquidation**. If all other methods are ineffective and the performance of the company is disappointing, the easiest way is to sell assets that have certain cost. In the liquidation the value of the land, buildings, equipment, machinery and other assets of the company is more than the company can earn by using these assets. Such scenario can be observed in industries experiencing difficult times. Over the years business can be successful and stable, accumulating assets not needed for activities such as land, buildings and some long-term storage facilities. Then comes a serious industry downturn and profit reduces greatly. At this point the assets if they are sold, and the generated money is put in the savings account, can cost more than the company itself.

Existing various opportunities for exit constantly relate to economic conditions and market interest in certain industry segments. Although it is very important for an investor to develop exit strategy in advance, he must be prepared to show flexibility and adaptivity,

²⁸ See Fraser-Sampson, 2010, p.120

when the exit moment is approaching. Investors also need to recognize when the adverse cyclical conditions of the market, where he was planning to make exit, produce signal to better choose another method. Ability to understand what is happening on the market and anticipate the onset of certain cyclical changes is a key skill of an investor.

There exists a misconception that the investor can cash out the cost of his investment by the IPO or direct sale. In fact, investor doesn't exit the investment until he changes illiquid assets of his personal share pack for more liquid ownership – in other words, as long as he doesn't get money for his shares in the portfolio company.

In case of the IPO there may be a significant delay of the moment when the investor can cash out the value of his shares. Since the main reason and goal of listing is to gain access to new sources of financing, the vast majority of shares offered for public are reissued. Providing liquidity to existing investors is only the secondary objective, which may also conflict with the main goal.

Thus, certain activities may restrict freedom of investors to sell their shares during an IPO. One of such restrictions can be the establishment of so-called period of 'freezing' (lock-up period), during which investors are not allowed to sell their shares to public. This measure is designed to avoid lowering of the share price and thus to protect interests of the new investors. Limitation of the freezing period remains usually for around six months after the release of the company's securities on the market. This limitation can act as one of the conditions specified by underwriters, and as one of the regulatory events by the authorities. Investor can only calculate his final profit after the period of freezing and after he sells shares of the portfolio company.

3.2. Initial public offering

Usually initial public offering, performed at the end of the fourth funding round can be considered as the crown of the new company's development, and the beginning of new phase of corporative history.

Main condition of the IPO is *incorporation* – process of transferring the company into a legal form of public company. Initial public offering may be preceded by the placement of shares by a group of qualified investors, which can be possible under certain requirements for performance and quality of corporate governance. Opportunity of IPO and new public company share issues is also associated with these requirements and

besides immediately at a high level, which can be difficult to achieve in a short preparation period.

Portfolio investors in a public market play a significant role in the price of capital employed. At the same time company's shares are available for a wide range of foreign investors, which entails both positive and negative consequences for a company. Public offering is usually accompanied by the inclusion of shares in exchange listing or output of shares on the OTC market. After the public offering the investor base of the company expands to institutional investors, called 'portfolio investors', as well as individual investors. From the one hand, it increases the liquidity of shares and thus offers prospects of growth in prices, which is beneficial for the shareholders as well as for a company itself, allowing to attract more funds under new issues and debt financing. From the other hand, it retains control over the company for the 'old owners', at the same time opening the way for unfriendly mergers and acquisitions and foreign investors to gain control over the company.²⁹

At the IPO company usually receives 15-20% premium to the price for purely technical reasons, as investors assess it not on the basis of the achieved data, but on the basis of forecasted financial data. Main problem of IPO is the maintenance of the price growth and shares liquidity, which depend on the scale of the company's operations. There are special technologies to improve stock prices of companies that appear on the IPO, technologies to increase the liquidity of shares or methods of accelerated price growth, when investing through the risk-free convertible instruments.³⁰

Important question at a certain moment - *Is the company ready for an IPO?*

IPO success is primarily dependent on the promptness of the company. Management should be set firmly, understand the obligations arising from the transition to the position of a public company and be sure that they meet expectations of the market.

Readiness of the company to execute IPO also depends on the openness and stability of its long-term financial model. Profitable companies, which successfully coped with entrepreneurial tasks, can survive the need to make their financial information public. It is necessary to understand the seasonal character of the business, since it affects the

²⁹ See Cumming, 2012, p.448

³⁰ See Cumming, 2012, p.449

quarterly growth model. Equally important is the stability of the company and management, as well as potential product development and technology.

Potential investors should immediately understand what does the company represent as a separate organization or as a group of organizations. It inspires confidence, so it is advisable to have a clear and distinct corporate structure, without intermediaries and subsidiaries with minority shareholders, preferred shares, special arrangements about share rights and control rights.

Financial department should be ready to provide current financial reports and other information about the company on demand of an investment banker. In particular – annual reports, quarterly reports and other information about the company.

Institutional portfolio investors live in a symbiosis with the company. Portfolio investors of the public market bet on the perspectives of the development of the company through equity and debt, as well as favorable conditions on the stock market, instead of company's development possibility through external investment, which is offered by a direct investor.

Portfolio investors perform through:

- Investment funds and companies;
- Brokerage houses, which buy shares through private placements and initial public proposes;
- Exchange and OTC market for shares, listed and traded in the market;
- Mutual investment funds that are opened for foreign investors;
- Listing on foreign stock exchanges, issue of ADR and GDR or foreign OTC market.

Portfolio investor usually does not require a large share package of one single company and it is preferable to form a portfolio of relatively small batches of shares of several companies, which reduces the risk and increases the liquidity of the portfolio. Therefore, direct investors prefer not to invest in the companies, whose shares are already on the market.³¹

A company, which decided to raise funds through a public offering should:

³¹ See Fraser-Sampson, 2010, p.92

1. Meet several requirements claimed by the public market investors, primarily in the area of corporate governance;
2. Have available shares ready for the placement (issued and properly registered) or at least get consent of existing shareholders to issue new shares in a form of a decision of the Board of Directors about the new shares issue.
3. To develop an effective program for improving the liquidity and price of the shares in the period after the IPO.

It should be noted that access to foreign market is significant for the company's image and its future, but unfortunately doesn't always lead to a substantial increase in the value of the company, despite of good fundamental indicators and insufficient size of the companies in emerging markets.

In conclusion it is to say, that after reaching the successful IPO target - process doesn't end, but comes to the beginning of a new life. Transformation into a public company is a process, which is difficult to move another way, though occasionally happens that some company gets into private hands again. During company's advance towards the IPO, it needs to prepare for a new status and new commitments of the public company reporting to public shareholders. These new requirements for all the new transactions in the sight of general public represent a radical transformation, which can both favor and hinder the growth and prosperity of the company.

4. Analysis of the current situation in the private equity market

In recent years due to the slow recovery of economy and unstable situation on the stock markets the globalization of private equity has intensified. Economic growth observed in the developing countries entails structural changes in the private equity market.

Globalization of private equity is manifested in different ways: from attracting foreign funds and companies access to foreign stock exchanges or sales to a foreign strategic investor and ending with more common practice of opening representative offices abroad and assistance to its portfolio companies on the new markets.

The trend towards development of emerging markets is reflected in the geographical patterns of distribution of existing and new global centers of concentration of private equity. Most likely the U.S. will remain a leader in the field of private equity financing in the mid-term, but in the last 10 years the amount of private equity investment in U.S. has fallen steadily. On the other hand in China, India and other developing countries there appear actively growing innovation centers and talented entrepreneurs, and investors are focused on a less risky transactions with new companies, which are on the later stages of development.

4.1. Private Equity industry overview

In 2013 there was announced 4011 venture transactions with a total volume of 33,2 billion dollars worldwide. These investments were made in various countries, sectors and at different stages: from investing in the creation of the companies and their initial development (angel and seed investments) to larger investments at later stages of growth.³² (*Appendix 2*)

Sharp decline in activity in the field of venture capital in 2009 demonstrated that PE market was seriously affected by the global financial crisis of 2008. Though the downturn in 2009 was replaced by growth in 2010-2011. In 2012 the trend in the market has changed: total number of funds decreased by 13% - from 323 in 2011 to 280 in 2012,

³² See Ernst and Young Report, 2014, p.8

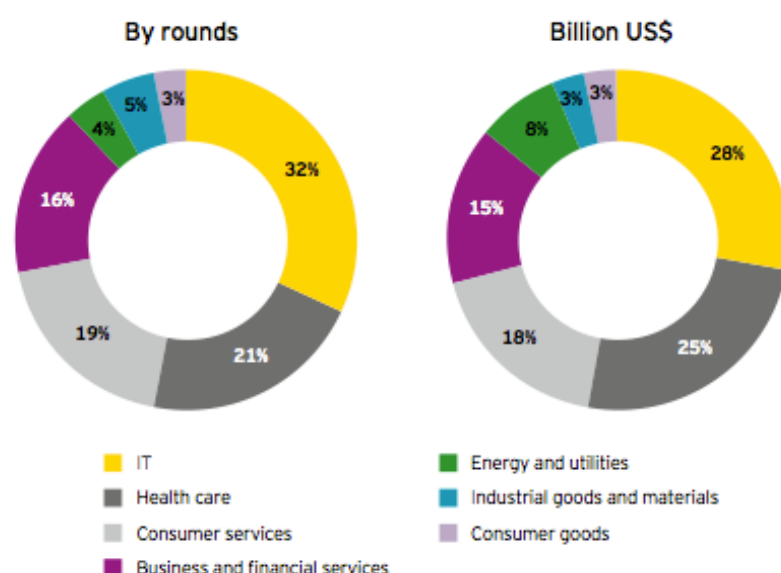
while the volume of transactions – from 46,8 to 33,2 billion dollars. These figures clearly demonstrate that the uncertainty in the world economy affected venture investments in the past two years.

Overall, on a global level there was a drop of investments in companies at all stages of development. However, of a most interest for investors remain companies which are at the product implementation stage, and the most noticeable reduction – with regard to start-up companies. (*Appendix 3*)

Worldwide markets are observing a decline in funding volumes at the beginning stages of development. However, even in the conditions of instability in the capital markets over the last five years, the average yield of venture investments the day after the IPO was 19%.³³

Over the past seven years (from 2007 to the end of 2013) the greatest amount of investment and the maximum number of transactions (86% and 88% respectively) accounted for four sectors: information technology, health of the consumer services, business and financial services. The leading position has an IT-sector, which on average is 28% of the investment volume and 32% of amount of transactions.

Figure 3. Global VC investment by sectors — average for a period of 7 years (2007–13)



Source: Ernst and Young Report. “Russian and global venture markets in 2007-2013”, 2014.

³³ Ernst and Young Report, 2014, p.9

Consumer services continue to hold leading positions in terms of the size of transactions in Europe and India, and a segment of consumer information services leads in terms of the amount of investment. According to the results at the end of the third quarter of 2013 its share in Europe and India had 20% and 45% of the total number of transactions in this sector. Sectors of business and financial services, consumer and health services show tendency to increase in terms of exiting through the IPO.³⁴

Recently, private equity investment funds tend to adjust their investment strategies, preferring to invest in companies already receiving profits and paying less attention to those who are still engaged in the development of the product. Companies at the stage of the receipt of proceeds continue holding main positions in the activities of venture capital funds by the number of trades and investment volume in all the markets. As the investors interest moves towards the companies at later stages of development – investment risks are reduced and the size of the funding round increases. At the same time, the American PE capital funds allocate smaller amounts to invest in companies in the late stages of development.

It is interesting to note the continuing decline in the number of active investors in the U.S. and Europe. Transition of the initiative in the hands of smaller number of stronger players suggests the consolidation of the market. According to Probitas Partners Private Equity Survey in the emerging markets investors are mostly interested in China and Brazil; they also show interest in Russia, though are concerned about de facto investors' rights and alignment of interest in the Russian market.³⁵ (*Appendix 4*)

Currently GPs, attracting capital of foreign LPs, invest in companies abroad as well. Minority investors, in turn, prefer the more successful funds, having a good reputation, experience and positive investment history. Reputation of a PE fund is very important. Funds, which have better reputation, can dictate terms and pay less (10-14%) for the shares acquisition in the companies. Market leaders earn reputation by effective investment activities. Reputation is valuable not only because it allows entering into transactions with portfolio companies on more favorable terms, but also because it in itself increases the value of these companies. Funds contribute to the growth of portfolio company by mentor activities such as participation in the board of directors, corporate governance, human resources management, coordination and strategy development.

³⁴ Ernst and Young Report, 2014, p.10

³⁵ See Probitas Partners Report, 2013, p.6

Reduced investment activity is partly due to the legitimate pause on the background of unstable situation after two years (2010-2011) of significant growth. As GPs face increasing difficulties when along with exiting portfolio companies - capital flow, returning to LPs, decelerates. This, in turn, limits the ability and willingness of investors to invest in new funds. Underperformance of many venture capital funds in comparison to stock indices such as Dow Jones and S&P500 also contributes to the fact that the LPs reinvest in the funds.

Exit trends

For more than 10 years PE investors face difficulties in exiting from equity of portfolio companies. Since the late 1990s up to 2004 (the moment when Google held IPO) market experienced the dotcom crash, and then the financial crisis arrived. In other words, for about of the last 10 years assess to the IPO market has been hampered.³⁶

Uncertainty of the world economy could affect the private equity market in late 2012. This was manifested in the reduction of the number of outputs of PE funds through the IPO's and M&A, which in turn led to a decrease in their activity in terms of investment in the early stage development.

IPO remains to be the most attractive way of assessing venture capital investors, despite the fact of possibility of sale of the complete share in an IPO is becoming less likely, and the time of the preparation for the placement increased, compared to 2007, especially in the U.S. and Europe.

In contrast, there is a clear trend observed to *shorter exit* through M&A transactions in the U.S. and Europe, allowing hoping to reduce the time of exit in general. Average time of exit through an M&A in the U.S. reduced sharply – to 4,4 years, so it can be assumed that there appeared a new generation of companies, emerged after the collapse of dotcoms.

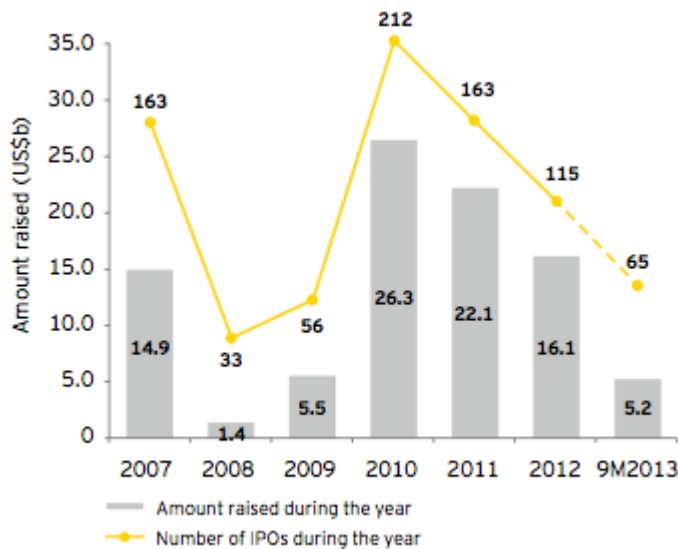
Another trend is that many venture capital funds retain their shares in companies after the IPO, keeping the interest in effective performance of previously controlled companies.

³⁶ See Global Private Equity Report 2012, p.13

Global venture IPO market

Amount of the capital raised in the IPO has decreased over the last three years by 38% from 28,6 billion dollars in 2010 to 16,1 billion in 2012. 2013 was also not simple for PE-backed IPOs. After three quarters of 2013 market of PE-backed IPOs returned to the level of 2009.³⁷ (65 transactions and 5,3 billion dollars)

Figure 4. Global venture-backed IPOs, 2007–13 YTD (numbers of deals and total money raised, US\$b)



Source: Ernst and Young Report. “Russian and global venture markets in 2007-2013”, 2014.

The number of IPOs in the world fell by more than 46% in 2010-2012 from 214 to 115. The most notable decline was noted in China, where the number of IPOs during this period decreased by more than 50%. Despite this, China accounted for the largest number of companies in the world becoming public. U.S. opposed a global negative trend and demonstrated double amount of funds raised in 2011, but this was achieved mainly due to the Facebook IPO for \$6,8 billion.

Private equity market continues to consolidate. LP-investors give preference to the most successful and well-known funds, from which one can conclude, that the consolidation will continue in the future.

³⁷ See Ernst and Young Report, 2014, p.20

Europe

The performance of the EU private equity industry is negatively influenced by overly complicated and unsuitable organization of funds, which is not conducive to interstate investment. Additional costs and additional risks faced by investors make the European private equity industry less effective than it could be compared to the U.S. This situation is particularly unfavorable for PE funds, as well as for players acting in small and less developed markets. Interstate direct investment should become a usual way of financing projects in the EU, as well as other financial transactions.

In 2012 the figures on the venture capital market showed downturn, but in 2013 there were signs of recovery. In the third quarter of 2013 activity of venture capital funds increased by 4% in terms of borrowed funds and by 7% by the amount of deals compared to the 3rd quarter of the previous year. Increase, albeit small, can be expected as a change of the current negative trend. However, decline in the amount of attracted funds in Europe in 2013 continued. The number of new funds decreased from 101 on 2007 to 37 in 2012 and to 20 in the first three quarters of 2013.³⁸ It is also important to note, that the data for 2013 shows stabilization of the funds size. This suggests that the level of the investment activity can also stabilize.

Investors still prefer to invest in companies at later stages of development. Amount of investment in companies at the stage of making profit decreased slightly compared to 2012. In the 3rd quarter of 2013 in Europe the median size of investment in such companies was higher, than at the stage of getting profit. When making investment decision investors still require from companies the confirmation of viability of the company – availability of revenues and customers.

Average deal size in Europe remained relatively small in 2013. That means, that venture investors continue to stay cautious when making large investments. Since 2008 the average deal size on the key markets – Great Britain, France and Germany – remains within 4,7 – 5,4 million dollars.

In Europe the business and financial services sector has become a leader in terms of investment in the 3rd quarter - during 81 transactions were attracted 388 million dollars. Leader on the size of investment in Europe remained the sector of consumer services, which became the most popular segment of the consumer information services. In the 3rd

³⁸ See Ernst and Young Report, 2014, p.23

quarter of 2013 the share of this segment accounted for 20% of the total number of transactions made in this sector in Europe.

Wharton Private Equity Review of 2013 remarks, that out of \$200 billion of new capital, which went to private equity market in 2012 worldwide, 20% (\$40 billion) went to fund managers in emerging market countries. Though only \$15 billion of that sum was supposed to go to BRICs (Brazil, Russia, India and China), which shows substantial growth in the non-BRIC emerging markets, such as South Africa, Mexico, Chile or Peru, as well as Indonesia.³⁹ This can be a topic for another discussion, but I am going to focus on one of the emerging countries – Russia.

Role of Russia in the global private equity market

Russian private equity market is growing rapidly in recent years. The most conservative estimates indicate that in 2007-2012 Russian venture market showed at least a quadruple increase in terms of both volumes of investments and in terms of the number of transactions. In 2007, estimated amount of the Russian PE market by RVCA, accumulated on the basis of 34 deals, made up 108,3 million dollars. By 2009 annual investment volume increased by 49%, while the number of transactions has doubled. The world financial crisis at the end of 2008 had a negative impact on market performance in 2009, but the recovery was quick. In 2010, further growth by 24% was observed compared to 2009.⁴⁰

However, it should be noted, that the market for private equity in Russia is nevertheless constantly evolving. The most common way of exit in Russia at the moment is sale to a strategic investor, at the same time IPO remains to keep a big part of such transactions.

In the end of January 2013 it became known that the results of studies of Dow Jones Venture Source Russia showed Russia climbing to fourth place in Europe in terms of venture capital into the high-tech sector. Commenting on this result experts of Dow Jones Venture Source Russia and analytics of The Wall Street Journal notes that in this sector in Russia there is a boom of venture investment.

³⁹ See Wharton Private Equity Review 2013, p.3

⁴⁰ RVCA Yearbook 2013, p. 10

If in 2010 Russia was lagged behind in terms of PE investment, at the end of 2012 she entered the top five innovative leaders in Europe. At the same time positive conclusions of the above-mentioned sources can be regarded as quite conservative. Considerable degree of secrecy and opacity of the Russian market leads to the fact that a substantial number of transactions don't come to the attention of analysts and researchers. Not only basic parameters of transactions remain unknown, but also the fact of conducting them.

Russian state plays a significant role in the development of innovative economy. In the early stages of the history of Russian venture capital market, mainly in 2004-2009 the government has established several state development institutions, which increased interest to the new economy, innovations and entrepreneurship in society and business circles. At the same time there were made significant effort to make the tax regime favorable to the business.

Although the role of resource economy in Russia remains very high, new economy becomes noticeable. Increase in the share of high-tech and innovative enterprises is outpacing the GDP growth. Much of this growth can be attributed to the development of institutions created by the state.

4.2. Problems and perspectives of the PE market further development

The main reason for a decline in the investment activity in 2012 was the continuing economic uncertainty, which arose as a result of the debt crisis in the Euro zone and its negative impact on the investors' sentiment. Tightening the regulation of the European financial sector by means of such legislative initiatives as Solvency II and Basel III, also contributes to the decline of investment as tougher regulation and higher capital requirements have negatively affected the desire and capabilities of market participants to invest in European venture capital markets. In some cases changes in tax legislation played a role as well. For example in France the reduction of tax breaks for individuals who invest in venture capital funds contributed to the inflow of investors and as a consequence, the investments in the portfolio-owned companies.

John Daly emphasizes in the Wharton Private Equity Review, that the new era for private equity regulations in the U.S. is coming. Demands for the market transparency have grown over time, and now have placed PE industry in the spotlight. It began in 2006, changing the meaning of fair value in generally accepted accounting principles, which directed PE firms to mark-to-market their portfolio holding instead holding them at cost. Next significant step in this direction was the Dodd-Frank Protection Act within the Basel II framework signed in July 2010, which required most PE firms to register by the SEC as well as limited banking entities to own more than 3% total interest in alternative asset funds (Volcker Rule).⁴¹ President Obama also proposed for the budget 2015 further restrictions regarding 'alternative investments' concerning the close of 'carried interest' tax loophole.⁴²

Funds expect to be impacted by the new regulations, as well as they fear restrictions in the fundraising activities and increased costs.

Europe

The crisis turned up as a test for the European private equity industry due to some reasons: widespread economic uncertainty, lack of the investment quality goals, weak prospects for profit, inability to satisfy expectations of sellers and buyers, extreme difficult accessibility of borrowed funds. At the same time, the recession created a need to focus on the existing portfolio companies. As a result of the crisis, funds management has become very cautious to investment decisions, which resulted in reduction of investments in general. Liquidity restrictions, which the investors had to face, hampered fundraising, while the reduction of income opportunities decreased the availability of borrowed funds. All these factors combined with a significant increase in the cost of debt servicing, appeared to be the major obstacles for the development of the industry in Europe. And to top it the broad economic crisis strongly affected the performance of companies in all sectors of the economy, including many portfolio companies. As a result, private equity funds have directed their effort on their existing portfolios, trying to help them survive the crisis by injecting additional equity capital in them, enhancement of operational support and improving the management system.

⁴¹ See Wharton Private Equity Review 2013, p.5

⁴² See Reuters: <http://www.reuters.com/article/2014/03/04/us-usa-fiscal-tax-idUSBREA2303520140304>

At the moment Europe seriously needs a homogenous market on which world-class companies can thrive. As it was established by the policies of the European Union, European private equity industry is at the center of measures to achieve Lisbon goals for growth, innovative development and competitiveness. Development of this industry should be supported by the creation and development of a standards and recommendations set, developed under participation of politicians and other interested parties.

Russian PE market

In the coming years the economic development of Russia will be determined by its ability to raise capital for the development of scientific and technical potential of the country. Private equity financing is one of the most effective and proven in practice financial support measures.

The main problem for the development of Russian PE industry is caused by some factors, associated with the development of the Russian economy. First of all it concerns unresolved issues in the legal environment – imperfect structure of funds, problem of protecting the rights of minority shareholders, excessive tax burden on small and middle capitalization companies, protection of rights on intellectual property etc.

In my opinion, Russian private equity industry is still in the very beginning of the way, talking about the size of the market, the experience and the level of expertise of its members. Despite the presence of positive dynamics, the pace of development of the innovational and technological economy in Russia is not enough to maintain its position relative to other countries. The reason can be in the absence of fundamental interest in the development of innovations. The main task of the private sector in Russia is making money using the current moment. And it is still the question if the country aims to create an open and transparent market of the private equity investment.

To mention are three things, which in my opinion are absolutely necessary for a qualitative change in the situation. First, Russia needs a legal state with applicable law, independent courts, protection of property and a free mass media. Second, there must be competition. At the moment the level of competition is low or there is even no competition in many segments of the economy, and it continues to reduce as a result of direct or indirect nationalization of the economy. Third factor is the elimination of customs barriers

related both to import and to export for the effective cooperation of Russian start-ups and innovative companies with foreign component suppliers and consumers.

Conclusion

Mission of the private equity industry is to play an important role in developing of European companies and help empowering them. Financing in the form of private equity investment can improve management and administration of the company and serve as a springboard for their flight to sustainable success. Private equity investment creates value. As an investment partner, industry is vitally interested in ensuring long-term viability of the company in which it invests.

Private equity investment can also provide the desired return on investment for the by nature long-term organizations, contributing their money and thus making contribution to the increase of portfolio revenues, required for the infusions in long-term savings and pensions of the population.

European industry of private equity has bright future: Europe has all the possibilities to become 'home' for the successful and developing industry of private equity investments. Many conditions necessary to maintain the emerged in recent years growth are implemented. However, situation is heterogeneous. Some EU member states have realized the importance of the dynamic development of the industry of private equity investments and organized the required favorable environment. Other jurisdictions are recommended to implement the best of the existing practice examples.

European politicians should get acquainted with special features of private equity industry. This is not the case, where one can confine itself only with declarations. Here politicians will need to spend their time and attention to creating such environment, where the laws, concerning finance and companies, would not generate unforeseen consequences for unique business models underlying the developing European private equity industry.

It is also necessary to ensure that regulatory and tax regimes of different countries were linked to each other on the European level. With the development of industry, managers and investors will expand their investment horizons. The frequency and size of interstate investments will increase. However, these investments abroad and fundraising are now forced to take place on the background of fragmentation of the tax and legal systems. There is need for a better coordination of state systems. In particular, the need is to find reasonable methods to ensure that the fund managers and private equity investors do not bear losses in case of foreign investment. It is also necessary to get rid of some excessive complexities of legal order, which give rise to difficulties for

managers/consultants when they present their business to the qualified investors from other EU member states.

Private equity industry proved itself as a responsible part of the financial system, which acts certainly focusing on the needs of professional investors. Existing combination of self-regulation and country specific conditions for doing business is acceptable. All that is needed is to state power structures to realize that businessmen managing private equity investments abroad are already a subject to taxation and various regulatory influences in their own country. On this basis, I would like to see the industry free of the double taxation and legal uncertainty, so that there would be no need to resort to off-shore methods, having advantages in this respect. The possibility of such transformations is proved by many examples of other segments of financial services industry. Gained experience and potential in the industry, as well as positive changes in the structure of the market give a hope, that in the nearest future the Russian market of private equity will continue its steady development.

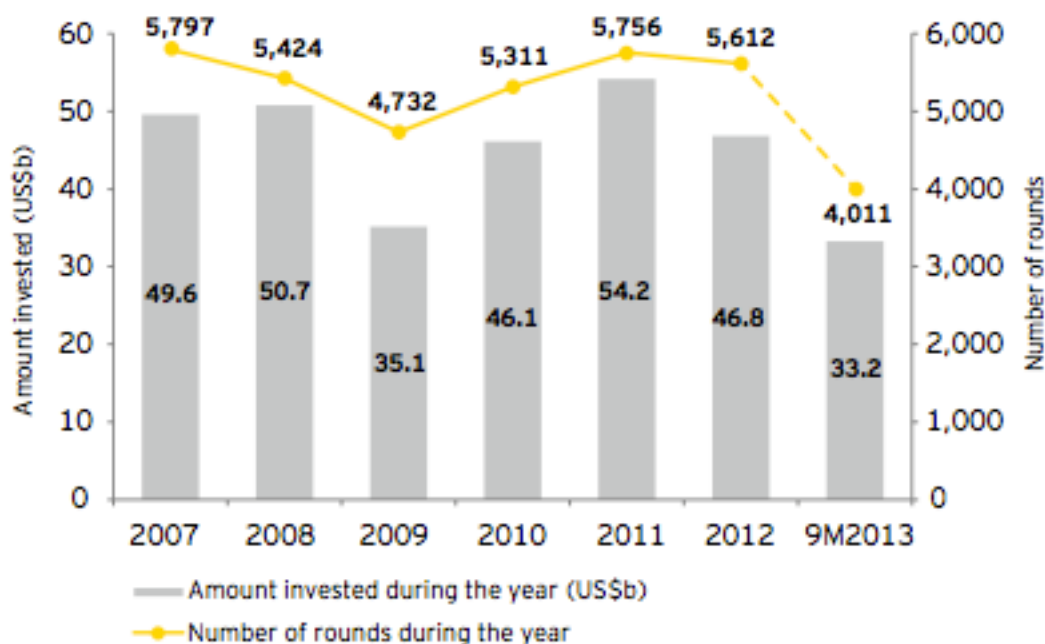
Appendix

Appendix 1. Evolution of the PE market

Private equity industry	
Before 1970	<ul style="list-style-type: none"> • 1907 - Creation of Bessemer Trust • 1934 – Formation of Charterhouse Development • 1945/1946 Creation of Industrial and Commercial Finance Corporation (later 3i) in Europe and American and Development Corporation (ARD) in U.S.
1970-1979	<ul style="list-style-type: none"> • 1972 – Establishment of Kleiner Perkins, Sequoia Capital, Sofinnova Partners, Adams Street Partners • 1973 – Establishment of US NVCA
1980-1989	<ul style="list-style-type: none"> • 1983 – Establishment of EVCA • 1985/1987 – Creation of Blackstone Group and Carlyle
1990-1999	<ul style="list-style-type: none"> • 1993 – EVCA published Guidelines for company valuation • 1996 – Publication of first statistics on the private equity industry activities
2000-2009	<ul style="list-style-type: none"> • 2001 – In Europe mobilized venture capital exceeds the capital for buyouts • 2006 – Record level of mobilization of capital in Europe • 2007 – Biggest buyout in European history – 14,1 billion EUR (Alliance Boots)

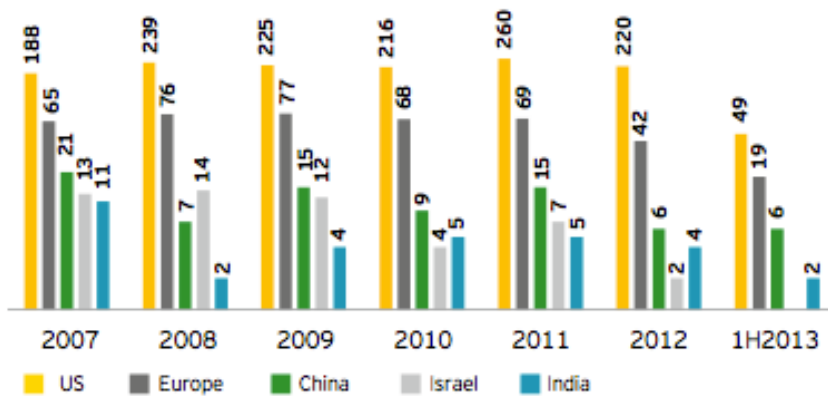
Source: EVCA.

Appendix 2. Global PE market 2007-2013 YTD



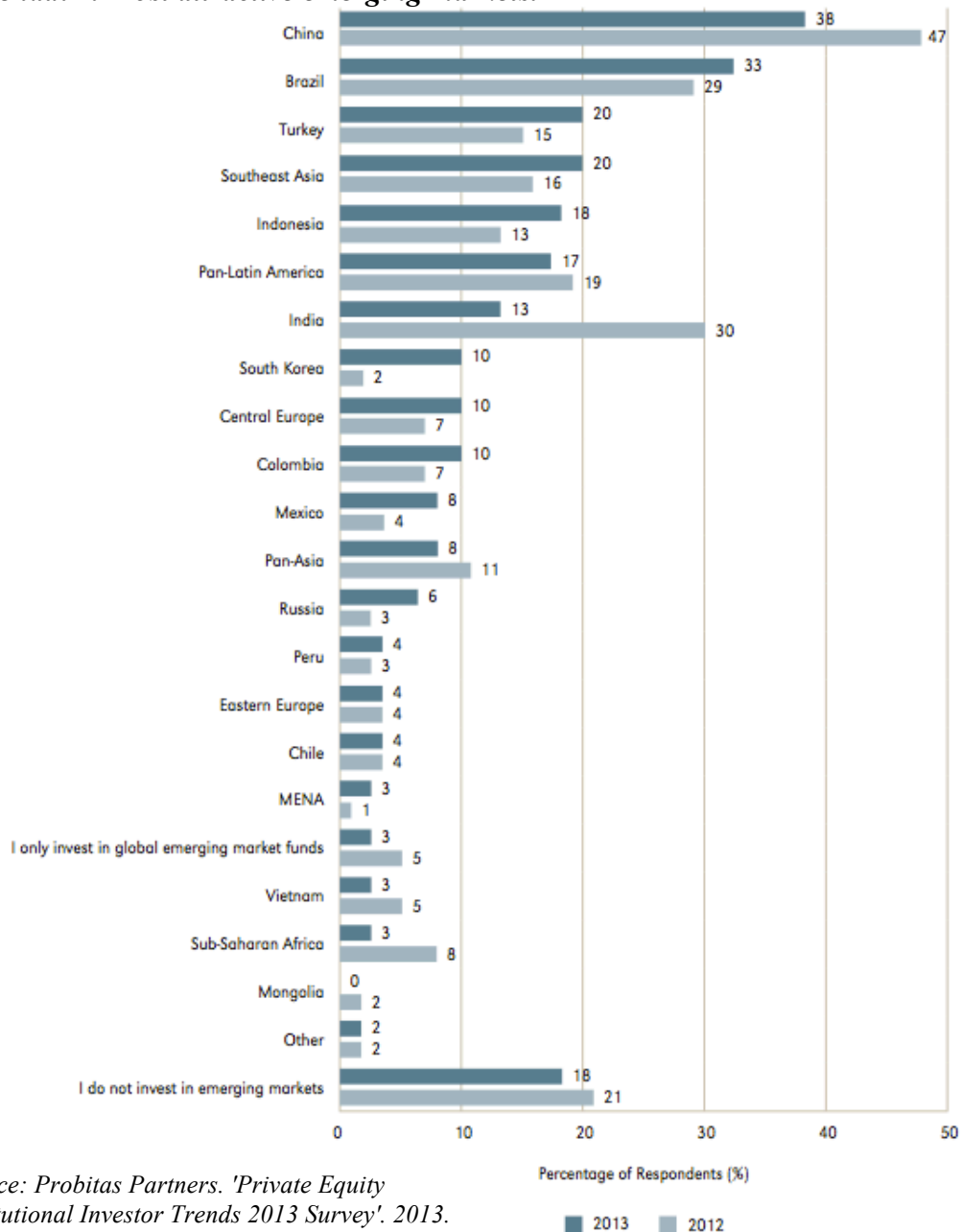
Source: EY Private Equity Report 2014

Appendix 3. VC investments at start-up stage 2007-1H2013 (by number of deals)



Source: EY Private Equity Report 2014

Appendix 4. Most attractive emerging markets.



Source: Probitas Partners. 'Private Equity Institutional Investor Trends 2013 Survey'. 2013.

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Verpflichtende deutsche Zusammenfassung der Arbeit

Private Equity Investitionen sind ein wesentlicher Bestandteil der Vielzahl von alternativen Investments geworden und sind weltweit als vertrauenswürdige Anlageklasse anerkannt. U.S. Kollegen folgend, haben die europäischen Investoren in den letzten 10 Jahren deutlich Investitionen in Private Equity erhöht. Trotz der stetig steigenden Interesse an Private Equity, gibt es immer noch viele Investoren weltweit, die entweder wenig oder gar nichts mit dieser Anlageklasse zu tun haben. Vernachlässigung von Private Equity erfolgt wesentlich wegen mangelndes Wissen in diesem Bereich.

Das Ziel meiner Magisterarbeit ist die Konsolidierung den theoretischen und praktischen Hintergrundes in dem Private Equity Bereich, sowie das Verständnis von Entscheidungen im Bezug auf 'Exit' Prozesse, konzentriert auf Private Equity Investitionen im europäischen und russischen Markt.

Mangelnde Transparenz in der Private Equity Branche bleibt als eine Herausforderung für viele Investoren, als auch für die Manager. Obwohl die Investition in Private Equity zweifellos die spannendste Investitionsart im Vergleich zu anderen Assetklassen ist.

Curriculum Vitae

EDUCATION

UNIVERSITY OF VIENNA *Vienna, Austria* 03/2012 – 02/2014

Master of business administration

FINANCIAL UNIVERSITY UNDER THE GOVERNMENT OF RUSSIAN FEDERATION *Moscow, Russia* 09/2006 – 07/2011

Specialist in world economy for monetary and financial sector

UNIVERSITY OF POTSDAM *Potsdam, Germany* 10/2010 – 04/2011

One-semester study exchange program

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EXPERIENCE

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Credit Analyst Intern

- Financial analysis of banks and financial institutions predominantly in Eastern Europe.
- Cooperation with client coverage, trade finance and global markets with respect to establishing new limits.
- Management of the credit approval process.

Gazprombank JSC 07/2009 – 08/2009

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Project Financing Intern

- Preparation of financial offers, financial calculations, research for potential customers.
- Responsibility for business correspondence with financial establishments.
- Involved with the calculation and establishment of financial limits of the customers.

Technologica Solution 10/2009 – 04/2010

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Strategy implementation manager

- Carried out administrative work in newly established startup (distributor of biotechnological products), including registration and regulations with authorities.
- Participated in a set of negotiations with partner firms on behalf of the company's owner.
- Took an active part in planning strategy for the company's development.