Private equity

What is private equity?
Private equity is a form of investment to provide risk capital financing for companies that either are not listed on a stock exchange or (in exceptional cases) wish to delist. Investments are usually made at an early stage in a company's development, when its chances of success are uncertain and the risks are therefore high.

What risks are associated with private equity?
Private equity investments are not usually subject to regulation, in particular with regard to investor protection. Because of this and their lack of transparency (e.g. limited disclosure of financial accounts or no publication), they entail higher risks for investors. This is especially true for private equity vehicles domiciled in countries with comparatively relaxed legislation.
Private equity investments involve considerable risks and can lead to substantial losses, including total losses. They are also geared to the long term and often have highly limited liquidity.

Financing types and strategies
Private equity involves investments in young companies (start-ups) and companies with growth potential that are still in an early stage of their development. This category is termed venture capital. Private equity is also used to fund the growth or expansion of an existing company. This is known as late stage or mezzanine financing. Private equity also comes into play when a company is about to go public or be sold. This type of financing aims primarily to refund the existing owners' original investment with a premium (multiple) from the proceeds of the initial public offering (IPO) or sale. Changes of ownership, for example when a company is delisted or sold to a strategic investor, generally involve some kind of buy-out: a management buy-out (MBO), management buy-in (MBI) or leveraged buy-out (LBO).
The primary goal of private equity is to invest in a company for a limited period and then sell the investment at a profit. The success of a private equity investment therefore depends not just on choosing the right time to enter or exit or sell the company, but also on the financing strategy the management has implemented. The strategies differ depending on the stage the company has reached. They include venture capital strategies, buy-out strategies, turnaround strategies and mezzanine strategies. The choice of financing solution, whether direct or indirect, will depend largely on the market conditions prevailing in the investment environment at the time. The performance of the equity and bond markets, as well as other specific private equity factors, will determine how easy or difficult the exit phase is and whether the proceeds meet expectations.

Special risks
Normally, private equity investments cannot be sold until some years after the original investment. There may be no provision for any interim distributions, or at least not until after a few years. In this case, the only prospect of a return is the capital gain that can be realised when the investment reaches the end of its term. In some cases it may be difficult to transfer the investment to another bank.
Companies that are potential candidates for private equity investments may have high levels of borrowing and therefore be more sensitive than established companies to negative market developments such as rising interest rates. There is also a greater danger of the company becoming insolvent and going bankrupt than with listed companies.
Private equity investors normally undertake in advance to invest a fixed amount (capital commitment) that may be immediately and irrevocably blocked at the bank. They may lose the ability to dispose of the capital as they see fit, even if the private equity vehicle does not require actual transfer of the full sum or part of it until later. This is known as making a capital call. In other cases, investors must simply ensure that sufficient liquidity is available when a capital call is made. If they fail to meet the call within a defined time period, they may be subject to sanctions set out in the limited partnership agreement that may entail the loss of part or all of the investment.
Certain private equity vehicles provide for mechanisms whereby investors may, under certain circumstances, be required to repay distributions already made at a later date. This is known as a clawback or recallable distribution.
In exceptional cases, investors may be asked to increase their stake. Investors supplying new capital may increase their prospects of making a profit, but also increase the risk to which they are exposed by the same degree, which may include the loss of their entire investment.

Indirect investments in private equity

With an indirect private equity investment, for example via a private equity fund, the skills of the fund manager are key. There is no guarantee that the manager of a private equity fund will be able to make investments and generate profits that fulfil the expectations for this form of investment. In general, the managers of such funds receive performance-related bonuses or remuneration and are often invested in the fund themselves, giving them what is known as “skin in the game”. The risks of an indirect investment are essentially the same as those of a direct investment, particularly as regards the capital call mechanism and limited liquidity.

DISCLAIMER

This information sheet contains an extract from the brochure “Risks Involved in Trading Financial Instruments” published by the Swiss Bankers Association (SBA), the complete version of which can be consulted at www.swissbanking.org or on the Bank’s website (www.corner.ch).

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Cornèr Banca SA // Via Canova 16 // 6901 Lugano_Switzerland
Tel. +41 91 800 51 11 // corner.ch // info@corner.ch