Private Equity vs. Venture Capital: What is a Better Fit For You?

By Tommy Kim and Christopher Kim
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Private Equity (PE) vs. Venture Capital (VC). You suddenly realize that you are being presented with two similar, yet different types of capital sources. PE and VC investment management businesses offer investors different types of return on capital using unique risk profiles in long-term illiquid assets.

Whether you are interested in this side of the business as entrepreneurs and CEOs seeking capital or as investment managers seeking to expand your investment management franchise, they are two different type of businesses. As you are shopping for capital, here are the similarities and differences between PE and VC investment management and how they add value to our private capital market landscape and the global economy.

You had been confused at one point, not realizing that PE is actually different from VC. As you have met with both PE and VC managers, you now see that the difference is becoming clearer. Both VC and PE firms work with private capital investing in companies, add value over time, and exit investments through private sale or IPOs, public offerings. The biggest differences between PE vs. VC is in investment size and level of risk taken on each investment. In addition, PE and VC are fundamentally different in number of deals they do and the size of capital they commit to each investment. Furthermore, PE firms seek no bad deals, while VC firms expect some or many to fail and hope that few would become a unicorn, deals that would be valued over a $1 billion.

There are several types of private equity funds. Some specialize in one or more industries and others are industry agnostic. Some PEs focus mainly on control buyouts. Others only do growth capital with a strategic minority or take the second-largest shareholder position to the benefit of not having the responsibility of driving the investment, but rather to provide capable management to run the course of the business, allowing PEs to focus on financial advice and strategic support.

On the other hand, many large private equity funds invest in buyouts with control and growth capital situations. In the U.S., these types of funds can be as small as $500 million to $10 billion in investment capital. Assets under management or AUM can be two to four times this size. Larger PE funds also have a global footprint with funds allocated to invest regionally or globally. Some of the well-known global blue-chip funds are KKR, The Carlyle Group, Bain Capital, TPG, CVC, Blackstone Group, Morgan Stanley Capital Partners, Goldman Sachs Capital Partners, and many more. Some of the best performing Asia Private Equity funds are Affinity Equity Partners with Asia Pacific presence, MBK Partners with North Asia presence, and Navis Capital Partners with Southeast Asia Presence. All of these firms focus on value creation to make their investments work for their money. I had the pleasure of working with most of these firms to do just that.

Most private equity funds get their target and blind funds from financial institutions, such as national sovereign and state pension funds, private and public institutional investors, insurance

companies, corporations, religious foundations, academic foundations and endowments such as major colleges and universities, family offices, and high net worth individuals. Many PE funds pride themselves on delivering unique investment management schemes and return to investors. These organizations have internal operating teams or bring operating teams from outside to deliver business transformations and operating improvements to improve process, efficiency, relevance, agility, digital technology, and monitoring that add value to their portfolio companies over time.

Other improvements may include improving brand and product performance, improving existing sales channels, adding new digital e-commerce and mobile commerce channels, globalizing sales and marketing executions, and global sourcing raw materials and productions. Through these operating improvements, PE funds fast track business development and add specialized adjunct talent to support management teams. They are like the Special Forces of the private equity space.

Private equity deals are sourced through in-house deal teams, outside advisors, and through inbound inquiries. In PE, on average, about 100 deals are evaluated before an investment is made to any one company. On larger deals, the transactional value may range from $500 million to $10 billion. These deals may require club deals. A club deal includes where more than one PE fund participates to close a deal.

Many large, buyout deals are funded by both equity and debt. Companies with strong revenue growth and profit margins competing in attractive growth industries may be funded with more debt than equity, due to its ability to service debt with little risk of breaching the debt covenant. Many PE held companies are held for three to seven years before exiting.

Return multiples sought in PE, such as Money on Invested Capital (MoIC), are 2.0x to 5.0x with IRR at 15% to 50% range. The emphasis is on return multiplying over time. In PE, all investments are expected to succeed and bring a range of payback returns. Very few investments should lose money simply because PEs work with more proven and established businesses. Time to time, PEs buy control stakes in bankrupt companies at a large discount. Eventually, PEs sell these companies back to markets with good markups after making operating and product improvements.

According to Preqin, out of total $4.4 trillion AUM in 2020, there's $1.5 trillion in dry powder waiting to be invested by private equity funds worldwide. Global private equity AUM is poised to grow to $9.1 trillion at 15.6% through 2025 with $4.8 trillion, 53%, in buyout and venture capital (Preqin). Despite the on-going pandemic in 2020, number of deals are growing. Asia has already bounced back, followed by Europe, then North America. Especially the larger funds are favored to sweep up more deals. Nevertheless, VC deals are up by 40% YoY in 3Q 2020. LPs are favoring to pledge and renew capital to larger and more established funds vs. establishing new relationships with smaller GPs. This is due to restricted travel and facetime LPs have to deploy their capital. Once we return to the new normal, LPs may re-establish active relationship with smaller and new GPs. This may take 9-18 months post pandemic, as we experienced many LPs took sit tight and wait decisions during the Lehman Financial Crisis in 2008.

Based on Bain & Company's Private Equity Report, private equity has demonstrated steadier and reliable returns more than public equities. Private equity returns vs. S&P 500 show: 1 year, 18% vs. 14%, 5 years, 16% vs. 13%, 10 years, 11% vs. 10%, 20 years, 12% vs. 7%. Among private equity vehicles, Buyouts performed the best over 10 years, at 14.4% vs. 11.3% by VCs and Fund of Funds (Preqin). The presumption is that the quality of deals in Buyouts were better than other alternative assets. In 2020 Bain Private Equity Report, in 2019 private equity buyout value was $551 billion with 3,600 deals, an average of $152 million per transaction. In comparison, 2018 private equity buyout value was $607 billion in 2,936 opportunities, an average of $207 million per transaction (MacArthur).

According to Fortune Magazine, in 2019 $888 billion was raised for 1,064 private equity funds, about 40% were for buyout funds (Marinova). With rising purchasing multiples, pricing was rich to buyers, but a good time to exit. There were 1,250 exits and 3,500 investments with exits averaging $300 million and investments $160 million per transaction. As the private equity space has grown competitive and crowded, entry EBITDA multiple is getting richer with more than half paying over 11x EBITDA. Finding undervalued assets has become harder and creating value is no longer the only focus on bringing down cost through operating efficiency. Instead, more and more attention is given to revenue growth. As more companies increase reliance on digital sales, coping with the new normal as less people venture out and more people shop online, e-commerce shopping innovation and capability will drive greater demand and growth across many industries.

Funds cannot simply bank on buying assets cheap, but have to work harder to create value. In contrast, the best performers managing portfolio companies with strong assets in digital relevance with agility, portfolio companies that have deep understanding of their customers and strong operating excellence, will continue to outperform the industry with a wider margin. They also build a reputation as stellar managers to Limited Partners, or LPs.

Private equity and venture capital investment vehicles will continue to be important economic contributors for a long time. Winners and losers in this industry will be determined by their ability to be smarter and better than their competitors in the buying and building game, among both private equity and corporate investors.

Some are buying smaller and cheaper businesses to further build capabilities. To do this, they acquire and add on targets that can add value to an existing investment. They then roll out a successful merger to enhance operational synergy and business offering to consumers. Add on new capabilities that can add greater value to a larger business community without straying too far from its core values and competencies. This continuous improvement and value creation are what sets apart winners from the rest.

In contrast with private equity, venture capital funds can come from financial institutions, like investment banks as well as individuals and family offices. As talent and experience tend to be thinner in VC situations, a larger amount of people and support is involved, expertise in management and technology is available, in addition to the initial financial investment. This means that there is greater involvement by venture capitalists in all aspects. There is no silent partnership in VC investments.

VCs are specialized investors in high-risk profile investments. Some are specialized to invest in SEED and early-stage. Some invest in growth-stage only. And some invest throughout the full investment life cycle. Some VCs specialize in one sector and others invest in two or more sectors. You can find VCs specializing in Internet, technology, AR/VR, health science, consumer and retail, and invest in a range of industries. Like PE, the management team is one of the key criteria in investment. However, in VC investments, the strength of the management team and the business founders is central to the investment. Because VC investments have a higher chance of failure, capital allocation is usually small in SEED and early-stage. It can range from $50,000 to $500,000 with additional capital of $1-3 million committed based on milestones achieved by the

management team. The holding period for VC investments can range from two to five years. Successful investment return multiple can be 5.0x to 100.0x on Money on Invested Capital. About one in ten investments is expected to hit a home run.

Now, if you were to fully choose to work with one of these types of funds, what would these differences mean to you?

At a private equity fund, you will work with more proven companies, usually across any number of industries. You may work with some of the most seasoned bankers and operating managers in the business, and experience the inner workings of professional management firms with world-class talent who have prior work experience from top investment banks, management consulting firms, and blue-chip Fortune 500 companies.

As far as compensation, you will be very well paid, if not be part of the best-paying industry. You will work with many companies over time and learn the trade in each business. You may eventually settle with one or more industries to become an expert in those industries with one or more functional expertise. Private equity is like a well-oiled machine that knows where it is going and how it will get there at the time of making investments, not after.

You can work long hours at peak deal time and find yourself engrossed in each transaction for 60-120 days at a time. Most of the people you will work with are highly skilled in financial analysis and strategic and operations evaluations. Ultimately, all evaluations boil down to numbers and projections which show the anatomy of the company's future.

The highly competitive nature makes breaking into the industry incredibly difficult. On top of having a relevant degree from top colleges and graduate schools and experience as an investment banker, management consultant, and industry managers and executives, the interviewing process will include understanding financial and analytical concepts, high demand for strong EQ and IQ, and natural instinct in determining good deals from bad deals. You must be prepared and confident in what you can do and what you can offer to funds when you make the leap into this industry.

In venture capital, there is a stark difference. Here, you will work in a much narrower niche, like in technology or biotechnology, often at the cutting edge of discovery. Most of the companies you come in contact with will be extremely new. Companies like Starbucks, Google, Yahoo, Apple, Facebook, HP, Microsoft, Amazon, Alibaba, Zoom, Tesla all had VC fund sponsorship.

In the early-stage, your profit margin will be lower than in private equity, if any at all, for many companies. In some cases, VCs invest large capital at the pre-revenue stage because the business model is so promising to deliver strong returns over time. There is always the exciting possibility that you have been given the opportunity to invest in the next Facebook or Tesla, but as many promising businesses you come across, you will come across as many that will fail to meet your expectations.

As someone working in venture capital, you will need three things: capital, be entrepreneurial, and have great interpersonal skills and people-reading instinct. Since the nature of this sort of investment is fluid and changing as the business itself evolves quickly, you will be updating company financials and business strategies. You will need to be able to not only build relationships with the heads of these companies, but connect them to the people and networks that can help them become successful.

You can have prior experience as an investment banker, consultant, and entrepreneur. There is no limit to the skills and experience that you may be able to bring to a VC that will not only make you a good venture capitalist, but a great one. This creates an interesting culture around venture capital. Some may perceive this as more relaxed and diverse than what you may find in a private equity firm where you will be spending a lot of time pouring over financial reports and changing landscape in competition and macroeconomic factors. While this is an incredibly important part of both businesses, you will have a more hands-on relationship with the actual company as you have been with it since its inception.

Once again, you see that these two investment businesses are so very much alike, yet so different. You can be sure that private equity and venture capital will continue to be important contributors in our global economy and an excellent professional career for those who are qualified. In time, you may find yourself being pulled in both directions as you think about what you learned that got your attention and the questions that were raised as you continue to ponder on these fascinating industries.

This article is a chapter from a book *DEDICATION, a Journey to Leader, Scholar, Athlete, and Beyond*, co-authored by Tommy Kim and Christopher Kim. A book for future CEOs and global leaders. Available on Amazon: https://brandcapitalventures.com/publications.

About the Authors:
Tommy Kim is a motivational speaker and an inspirational leader. Tommy authored topics on leadership and talent, beyond economic crisis, private equity, venture capital, investment banking, management consulting, brand management, service and higher education. Tommy served as a Founder, CEO, COO, CMO, CFO at Fortune 500 companies, private equity, venture capital, and start-ups, managing P&L and $10 billion in cumulative transaction value. He is a Partner at Brand Capital Ventures and leads investment management, data and quantitative analytics in deal management, portfolio operations and organizational excellence, commercial acceleration, creative transformations, and talent management. He works in partnership with Asset Managers, Private Equity, Family Offices, Fortune 500s, and experienced Discovery Entrepreneurs to fast track investments, creative and commercial executions. Tommy graduated from Brooklyn Technical High School, a national STEM school. Tommy has a BA from Columbia University, an MBA from Columbia Business School, attended executive and post graduate studies at Harvard Business School and Stanford University with program coverage in: private equity, venture capital, cyber technology in fintech and cyber operations, free and open internet, immune health, inflammation and disease, Corona viruses, climate change impact, law, U.S. election results and impact, business subscriptions. Tommy received numerous service distinctions from corporate, civic, military, scouting, Presidential, Columbia Business School.

linkedin.com/in/tommy-kim-2852021

Christopher Kim served as a research assistant and is the co-author of the book *Dedication*. He has authored and made written and research contributions on newspapers, magazines, social media, and books since 2014. Christopher graduated from Cold Spring Harbor High School in Cold Spring Harbor, NY. He received a Congressional Nomination from NY-3rd Congressional District and is a Midshipman with Dean's Honors at the United States Naval Academy. He is working towards his Bachelor of Science degree in Engineering and Applied Sciences with a major in Quantitative Economics with Applied Mathematics. He served as STEM and weapons instructor, passed the initial phase of Navy SEAL Screener, and preparing to be a Naval Aviator. In addition to his Naval service and training, he's completed finance and quantitative analysis, business ventures and Peek MBA experience, and academic-leadership programs at: Harvard Business School, Stanford University, United States Military Academy, United States Air Force Academy, United States Coast Guard Academy, United States Army, Boys' State New York, and Boy Scouts of America. Christopher is an Eagle Scout and Summit Venturer. He is a recipient of Congressional Gold Medal and national level academic, athletic, civic, military, Presidential, and Congressional Distinctions.

linkedin.com/in/christopher-kim-b57570155