PEI MEDIA
PRIVATE EQUITY INTERNATIONAL

PRIVATE EQUITY: A BRIEF OVERVIEW

An introduction to the fundamentals of an expanding, global industry

By David Snow, Executive Editor, PEI Media

PEIMedia.com

PEI MEDIA
PEIMEDIA.COM

Private Equity: A Brief Overview

An introduction to the fundamentals of an expanding, global industry

By David Snow, Executive Editor, PEI Media

Section 1 Introduction

Private equity, in a nutshell, is the investment of equity capital in private companies.

In a typical private equity deal, an investor buys a stake in a private company with the hope of ultimately realising an increase in the value of that stake. There is today an increasingly massive and variegated industry devoted to pursuing wealth creation in roughly this manner.

The private equity industry, once a rather obscure collection of specialist investment firms, is now a major force in the world. It annually attracts and deploys hundreds of billions of dollars. Some (but not all) people and institutions that have allowed private equity firms to invest their money have enjoyed stellar returns. This record of success (or perceived record of success) has led to private equity enjoying a high degree of interest from investors, corporate executives, young professionals, regulators, politicians, the press and the general public.

Private equity, in a nutshell, is the investment of equity capital in private companies.

This primer, "Private Equity: A Brief Overview", is designed to give a quick tour through the basic structures and functions of private equity firms, funds and deals, as well as to note some important trends in today's rapidly expanding and transforming private equity market. I have bolded key terminology for easy reference.

PEI Media, through its flagship magazine *Private Equity International* and other publications, has been covering the global private equity market since 2001. I have been writing about private equity since the late 1990s. During these years I have on many occasions delivered my "private equity in a nutshell" explanation to new reporters, members of the mainstream media and curious friends. This primer is a slightly more elaborate version of these chats, but only slightly. For the sake of brevity, I deliberately have left out detailed information touching on private equity data, performance, tax, financial and legal issues. For these, you should consult the many educational materials available through PEIMedia.com, among other resources.

Before we begin, a couple of quick notes:

Although some media and industry participants use the term in different ways, the term **private equity** is used here to cover all forms of investment in private companies, from early stage venture capital to growth equity to leveraged buyouts to turnaround investments of financially troubled companies.

A private equity firm, in its most conventional form, is not the only type of institution engaged in private equity investing. But it is the entity that will take centre stage for the purposes of this discussion, as most of the private equity investment in the world now is conducted by private equity firms deploying capital out of dedicated funds that are typically structured as blind-pool limited partnerships (more on this later).

PEI MEDIA
PEIMEDIA.COM

Section 2
Private equity firms

The practice of multiple parties conducting business through a partnership is an ancient one. Among the earliest commercial partnerships were ones formed to raise money for seafaring ventures. The investors who stayed back home deemed it appropriate for the people who actually captained the ships to receive a disproportionate share of the spoils. In today's private equity trade, the private equity firms can be thought of as the ships, and the **general partners** as the captains who get a disproportionate share of profits (if there are any).

Private equity firms are groups of individuals who come together to pursue private equity investments. While almost all private equity professionals invest a portion of their own money, private equity firms today primarily deploy capital on behalf of others. These firms tend to be partnerships, similar in form to other private professional services firms, like law firms, for example. A private equity firm today might range in size from two people and a secretary to hundreds of investment professionals.

The business model of a private equity firm is as follows – raise capital from external sources, invest the capital in a series of private equity deals, sell (or "exit") those investments (often many years later), and return the proceeds from these exits to the external capital partners while holding back 20 percent of the total profits for the partners of the private equity firm. This 20 percent take is called **carried interest**. Carried interest is the gravitational pull at the center of the private equity universe. The general partners also earn substantial income from other fees, such as **management fees** and **transaction fees**.

Private equity firms usually raise capital for investments into a **fund**, usually in the form of a **limited partnership**, which is a kind of fund that gives control and a disproportionate share of the profits to the general partners, even though most of the capital in the fund tends to come from external investors. As **limited partners**, these investors have little control over how the fund is managed and agree in advance to the lopsided profit-sharing agreement, as well as to the other fees.

When successful, a private equity firm can create a fortune for its founders. Here's a very simplistic example - let's say a group of five general partners (often referred to as GPs) raises a $500 million fund and invests it in a series of deals. When those investments are finally all sold off, the resulting value is twice that of the fund - $1 billion. This means the fund has a profit of $500 million. As part of the profit sharing agreement, the general partners keep 20 percent of this $500 million profit, equal to $100 million. Assuming they all share equally in this windfall, each general partner keeps $20 million. Nice work, if you can get it. This example doesn't even factor in the other potentially lucrative management and transaction fee streams available to the general partners (to be discussed later).

The fortune-building possibilities of a private equity firm have led to the establishment of thousands of such firms around the world. As recently as the 1970s, it was hard to count more than a few dozen private equity firms, primarily venture capital and leveraged buyout groups located in the United States. Now there are private equity firms both miniscule and enormous in all the developed countries of the world and in most of the emerging markets. A testament to the flexibility of the traditional private equity firm structure, these firms pursue a vast array of strategies. A key similarity among all of them is fund structure: a limited partnership presided over by a group of general partners.

Who are the general partners? They tend to be individuals who have been able to convince investors that they will be skilled at investing capital in private companies, adding value to those companies, and exiting the investments in a time and fashion that maximises profits for the investors. The skills needed by GPs are highly specialised. They can be thought of as a set of competencies, not all of which are necessarily possessed by single individuals.

Key skills that groups of GPs must possess include:

- **Deal sourcing –** Private equity firms need to be skilled at finding attractive investment opportunities, at generating great **deal flow.** This deal flow will come from a network built up working in a particular industry, from aggressively developing contacts among senior corporate executives. If Bob the entrepreneur is thinking of selling his company, a GP wants to hear about this first. A GP may argue that his or her deal flow comes from exhaustive research into a particular industry, which unearths opportunities overlooked by others. Today a large percentage of investment opportunities go through intermediaries such as investment banks, who charge a fee to the seller, and whose job it is to secure the highest valuation possible, often in **auction**-like sale processes. Many GPs argue that they enjoy **proprietary deal flow**, meaning they source opportunities directly with the potential sellers, bypassing intermediaries. (Industry skeptics will tell you that many GPs overstate the degree to which their deal flows are truly proprietary.)
- **Research and due diligence –** Before agreeing to do a deal, general partners must painstakingly form a view on the future of a given industry or market, and then on the potential of a particular company within that market. The GPs must be able to deeply understand the inner workings of a potential portfolio company and, based on that, determine the right price to be paid for the company. Private equity GPs typically build elaborate models that tell them how

PEI MEDIA
PEIMEDIA.COM

their investment in a company will fare, given a range of assumptions about the future performance of the company. It may be that a company is forecast to do very well in the future, but that the valuation of the company currently offered to potential investors, according to the GP's model, produces a return for the private equity firm that is too low to be deemed acceptable. (Many GPs will claim that their competitors pay too much for investments, while they themselves exercise **price discipline** and hold out for investments that stand a higher chance of producing better returns.) Before a decision is made to invest in a company, the private equity firm must perform rigorous due diligence on its financial health, on the state of the market in which it operates, and on the backgrounds of the executives leading the company. GPs often pay external consultants to do some or all of this due diligence work. Failure to uncover an important weakness during the due diligence process can result in an investment disaster for the GPs and their limited partners.

- **Financial engineering –** This is a bit of jargon that refers to a dealmakers' ability to masterfully structure an investment to his or her best advantage. A good financial engineer will be able to rework a company's balance sheet and creatively apply capital-market products, most importantly corporate loans, such that the equity provider is positioned to gain as much as possible from the deal. GPs with experience in the financial markets often possess advanced financial engineering skills. These skills are most important when a portfolio company is being acquired, is itself making an acquisition or taking on new debt, or is being sold through an M&A transaction or in an initial public offering. Skeptics warn that many GPs have failed because they applied sophisticated financial engineering in situations where the actual business fundamentals of the company were not well understood.
- **Operating skills –** Once a private equity firm has made an investment in a company, the GPs are charged with adding value to the company, or at least monitoring it to ensure that its performance does not deteriorate. Many firms include **operating partners** – executives who have experience running a company in a particular sector. For example, a private equity firm that acquires a chemicals company will often appoint a former CEO of another chemicals company to run or oversee the new portfolio company. These operating partners may simply be there to support the incumbent management of the portfolio company, or they may entirely restructure the company, starting with the firing of the incumbent management team. They may also add new products, close factories, sell divisions and acquire new divisions. A GP with purely investment banking-style financial engineering skills may not have the wherewithal to effectively change the operations of a portfolio company. Likewise, someone who, for example, was a senior executive at a chemicals company for many years, may nevertheless not have the financial engineering skills needed to structure the best investment result.
- **Salesmanship –** General partners must gain the confidence of many parties. They must convince investors to sign up for lengthy commitments to private equity funds. They must convince the management of potential portfolio companies that they will make for valuable investment partners. They must convince potential buyers on the public markets or in the M&A market that their portfolio companies are worthy of lofty valuations. One finds no shortage of charisma and self-confidence among successful GPs, personality traits that result in their being entrusted with vast sums of capital for long-term management, and help them sell investments for more than what was originally paid.

A GP with purely investment banking-style financial engineering skills may not have the wherewithal to effectively change the operations of a portfolio company.

Private equity firm **hierarchies** vary from firm to firm. Typically the founding partners are in charge and take the lion's share of the economics. The other senior-most partners – often called managing directors, partners, principals or general partners – are almost always entitled to a piece of the lucrative 20 percent profit share of the limited partnership called **carried interest**. A staff of supporting investment professionals assist on generating deal flow, evaluating transactions and overseeing portfolio companies. The titles, moving downward, typically include vice presidents, associates and analysts.

Private equity firms today have larger and larger rosters of professionals charged with the managing the voluminous non-deal aspects of the business. These professionals include chief financial officers, chief operating officers, investor relations and communications professionals, general counsel, human resources professionals, technology and capital markets specialists. The addition of these back-office professionals is part of the **institutionalisation** of the private equity industry as it moves away from its scrappier boutique roots, where historically a small group of GPs did everything themselves.

Section 3
Private equity funds

Most private equity firms are in the business of managing private equity funds on behalf of investors. The management of these funds, usually structured as limited partnerships, involves a complex, staggered and years-spanning flow of cash from the investors to the general partners to the portfolio companies, back to the general partners and ultimately back to the investors.

The long-term and illiquid nature of private equity funds makes it difficult to measure their performance while they are active. And because these partnerships are usually strictly private, it is difficult if not impossible for outsiders to access meaningful information on individual funds. Private equity is therefore often described as an opaque, **non-transparent** asset class.

Private equity funds are heralded by their supporters as vehicles that powerfully **align the interests** of the general partners with the limited partners. Plainly put, GPs have a huge incentive to maximise returns for the limited partners, because bigger returns mean bigger carried interest payouts for the GPs. If the fund generates a loss or a mediocre return, the GPs "don't eat". Skeptics point out that even loser funds generate nice incomes for GPs thanks to payouts other than carried interest. That said, GPs get into the private equity business with the hope of building fortunes through carried interest. If things don't work out well, the other fees associated with private equity fund management are nice consolation prizes, but not overly exciting to ambitious GPs.

Private equity limited partnerships are sometimes called **blind-pool** investment vehicles, because the limited partners cannot "see" in advance what deals are going to be done. The GPs themselves usually have no idea what the ultimate portfolio of private equity investments will be, but must stick to the parameters codified in the **limited partnership agreement** (LPA). If, for example, a limited partnership agreement calls for the GPs to acquire power plants in the US, the GPs will get in trouble if they instead end up investing in Chinese internet start-ups.

Most private equity funds are designed to make a number of investments over a specified amount of time called the **investment period** (typically five or six years). Most funds have rules against any one deal getting too much capital from the fund. These **diversification** rules may stipulate, for example, that no one private equity investment can receive more than 20 percent of the capital from the fund. Some funds are created to do a single deal, but these will not be discussed here.

A discussion of the many kinds of private equity deals is further below, but in general, a private equity fund is used to make equity investments in private companies. Debt used in deal structures typically comes from other sources, such as banks.

Here is how a private equity limited partnership works, starting with a limited partner's decision to **commit capital** to the fund:

When a limited partner, aka an investor in a private equity fund, decides to invest, no money changes hands initially. Instead, the limited partner agrees to commit a certain amount of capital to a limited partnership, managed by the general partners. In doing so, the limited partner, or LP, signs a legally binding commitment to contribute capital to the fund whenever the GP requests it, up to the point where the LP's size of capital commitment is reached.

For example, let's say that a large (fictitious) institutional investor called Global Opportunity Corporation (GOC) has agreed to invest with a private equity firm called RockStreet Partners. RockStreet is raising a $1 billion private equity fund, and GOC agrees to commit $100 million to the fund as a limited partner. The fund eventually secures commitments adding up to $1 billion from GOC and additional limited partners.

The GPs of RockStreet now have $1 billion in "**dry powder**" to deploy. The RockStreet team finds its first deal, which will require $50 million in **equity capital** from the fund. RockStreet makes a **capital call** to its limited partners, requiring them to transfer to the GP an amount of capital equal to their pro rata share in the limited partnership. Because GOC has a $100 million commitment to the $1 billion fund (equaling 10 percent), it is required to transfer to RockStreet 10 percent of the equity needed for the deal, or $5 million. The other LPs send in the rest of the capital depending on the size of their respective commitments.

A year later, RockStreet does another deal, this time requiring GOC to send in $10 million. Over a total of five years – the investment period specified in the limited partnership agreement – a total of $100 million is **drawn down** from GOC and invested in a series of RockStreet deals.

In the meantime, the first investment done by the RockStreet team is a huge success. The intrepid GPs have managed to grow the value of the $50 million equity investment into $150 million over four years. However, this impressive progress is only calculated as an **unrealised return** because the investment has not yet been exited. In other words, none of the partners to the fund have received their money back yet. Happily, after four years, the RockStreet team sells the portfolio company in question to a major international corporation, realising $150 million in proceeds. This can now be counted as a **realised return**, because the investment has been liquidated and the GPs have cash in hand. Because this first deal has generated a profit of $100 million (over the $50 million in equity capital initially invested by the fund), it means **carried interest** of $20 million for the extremely pleased GPs of RockStreet. The full $50 million from the initial capital call is returned in a series of **distributions** to the LPs on a pro-rata basis, along with the $80 million in profits after the GPs have taken out their "carry". For GOC, this means it gets back its $5 million initial investment in the deal, along with profits of $8 million (remember that $2 million has been paid to the GPs as carried interest).

The GPs of RockStreet brag of getting "3x" **gross return** on the deal ($50 million times three equals $150 million). The LPs to the RockStreet fund are also happy, but remain cognisant that their own **net return** will be less after the carried interest and other fees are taken out. They also are aware that this is just one deal in larger collection of investments done by the fund, and so they hope the other deals work out as well.

The above description dramatically simplifies the complex back-and-forth capital flows of a private equity fund. The actual formula for returning the principal and profits to limited partners is far more complicated and described below in an explanation of a fund's "**waterfall**".

Over the "life" of the fund, which can last anywhere as long as 10 to 15 years, the GPs of the $1 billion RockStreet fund gradually make and then exit all of their investments in a collection of **portfolio companies**. One investment is held for eight years. One is held for a relatively brief nine months (a local newspaper calls this a "quick flip"). But eventually, all the investments go through **liquidity events** and all the cash proceeds are returned to the partners in the limited partnership according to an agreed-upon profit-sharing formula.

Some private equity firms will distribute profits to limited partners in the form of publicly traded shares, called an **in-kind distribution**. This can sometimes present problems when the value of the shares decline after they have been distributed.

Although there are different formulas for waterfalls, here is how a waterfall commonly used in the US works. It is often called a **"deals-realised-to-date" waterfall**: When a deal is exited, cash proceeds become available, and these are distributed in a certain priority set by the limited partnership agreement. Some of the proceeds are first held in reserve. Then, if there is any more cash available, the LPs are reimbursed for their capital contributions to the specific deal that was just exited. Then, if there is any left, the proceeds are used to pay back LPs for capital used in any deals that have been written off (gone bust). Then, if there is any cash remaining, it is used to pay the LPs back for any management fees they have paid. Then, if there's any cash left, the LPs are paid until they have received a **preferred return** on the capital already drawn down. In most funds, the preferred return is 8 percent per annum. After this point, if any capital remains, the GPs are paid an amount equal to 20 percent of the proceeds, and the LPs keep 80 percent.

A waterfall formula commonly used in Europe, sometimes called the **"all contributed capital first" waterfall,** usually sees the LPs get back all capital contributed to every deal before the GPs can begin paying themselves carried interest. This is different than the prior example, where some carry may be paid if the very first exit produces enough cash. It often takes longer for a GP to begin receiving carried interest under this "all contributed capital first" formula.

At the end of a fund's life, the GPs may be subject to what is commonly called a **clawback** if it turns out that they have overpaid themselves. In other words, if it turns out a GP group has actually taken 21 percent of a fund's profits, it may be on the hook to pay that 1 percent back to the LPs. This can be painful and even impossible if, for example, any of the GPs in question have already spent the money, died, gone through a divorce or left the firm. To avoid these painful clawback scenarios, some waterfall formulas involve escrow arrangements, where carry is temporarily put in a sort of lock box until a fuller picture of a fund's performance is known.

A private equity fund also charges fees that materially impact the net returns of the limited partners. A **management fee** of roughly 2 percent of committed capital is usually charged to the limited partner. These fees are ostensibly designed to pay for the operations of the private equity firm, but for more established firms with very large funds, these fees have gone beyond paying to keep the proverbial lights on. Management fees have become important sources of GP wealth creation in their own right.

An additional source of fee income to the GP comes in the form of what can generally be described as transaction fees, or deal fees. Not every GP charges **deal fees**. Venture capital firms rarely do. These fees usually see the GP charge its own portfolio companies for services rendered. For example, a GP may charge a portfolio company a monitoring fee, ostensibly for the service of overseeing the company's performance. When the portfolio company is sold, the GP might charge a fee to terminate the monitoring fee. Most limited partners now require GPs to share these deal fees, an arrangement that is spelled out in the limited partnership agreement. One such arrangement may have the GP sharing 80 percent of the income generated from deal fees with the limited partners. This sharing may come in the form of a **management fee offset** arrangement, by which the LPs see a reduction in the amount of management fees they pay equal to their share of the deal fees generated.

Some industry skeptics have wondered how deal fees square with the notion that GPs are supposed to enhance the financial standing of their portfolio companies. They also wonder whether deal fees also offset a GPs incentive to generate wealth through the carried interest, thereby putting the GPs' interests somewhat out of alignment with the interests of the LPs.

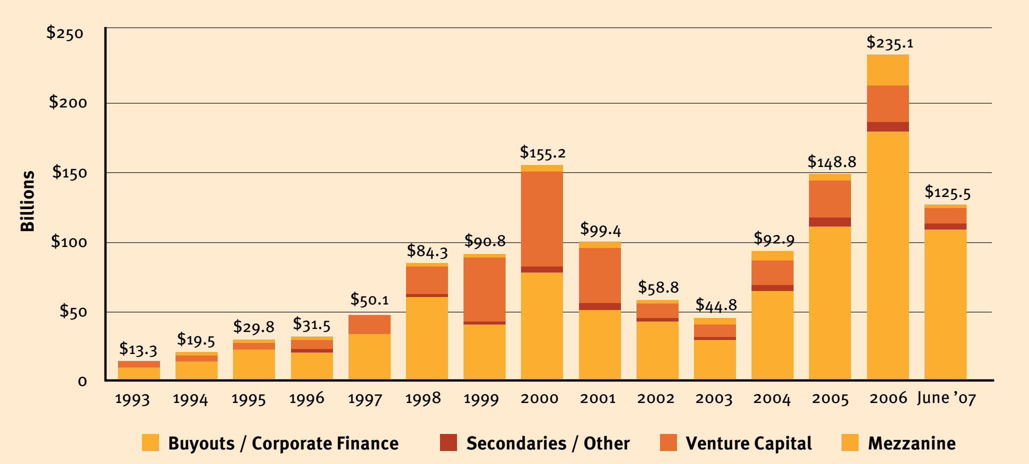
Section 4
Private equity fundraising

Before a private equity firm can get down to the business of managing a fund, it must raise the fund from limited partners. The private equity industry is today almost entirely dependent on the private equity fundraising market, and fundraising is still the lifeblood of private equity GPs.

Limited partners to private equity funds are overwhelmingly institutional investors and wealthy individuals. LPs include public and corporate pension plans, banks, insurance companies, sovereign investment funds, endowments, foundations, funds of funds (more about these below) and the professionally managed investment offices of wealthy families.

Over the years, private equity fundraising has increased dramatically (see chart).

A team of GPs may spend anywhere from two weeks to two years in the fundraising process, depending on the level of demand from LPs and other factors. GPs create a **private placement memorandum** (PPM), essentially a thick document detailing the strategy, terms and risks of the proposed fund. More importantly, the GPs and/or their fundraising representatives will often travel to visit limited partners and persuade them of the attractions of committing to the fund.



Commitments to U.S. Private Equity Partnerships by Sector

Source: Dow Jones

The fundraising market is the greatest barrier to entry in private equity. If a team of general partners have not previously managed a fund together, it is often difficult getting LPs to commit, regardless of the merits of the investment strategy. Limited partners often want to see a group's previous experience, or **track record,** investing together and profitably exiting from several private equity transactions. A firm that has one or more previous funds who has already delighted LPs with capital distributions will have a much easier time persuading LPs to "**re-up**" for a follow-on fund. New investors are also easier to attract when there is an established track record to point to.

Some market observers argue that LPs don't take enough chances with "**first-time funds**". Often these groups are highly motivated and in possession of unusual market insights and skills. Others see too many risks in new GP groups.

Private equity firms will often hire **placement agents** to advise and assist them in arguing their case to prospective investors. Placement agents are paid a negotiated fee often based on the amount of new capital they raise for the fund. Increasingly, private equity firms are bringing on board in-house **investor relations** professionals to perform fundraising duties as well as keep investors apprised of all developments throughout the life of the fund.

Fundraisings are usually launched with a **target** in mind, sometimes stated explicitly on the cover of the PPM, sometimes not. A GP will argue the target size of a fund is appropriate for the targeted investment opportunities. For example, a firm that says it specialises in doing deals that require between $25 million and $100 million in equity per deal may target $750 million for a fund to complete roughly 7 to 10 deals before needing to go back to investors for more capital.

Fundraisings are sometimes divided into **closings.** If a firm has raised a certain amount of capital, it may hold a **first close** on an amount shy of the total fundraising target. This allows the firm to begin making investments. A final close means the limited partnership in question is through raising capital. Sometimes funds hold final closes on amounts well below their stated targets, which can be embarrassing for GPs and signal that LPs didn't have as much demand for the fund as originally thought. Frequently fundraisings are canceled when the GPs fail to garner enough commitments, although you won't often read about such failures.

The more trumpeted fundraising story occurs when a fund is **oversubscribed** – when a fund has raised more capital than the target. Some funds are met with such demand that they raise two or three times more than originally planned. LPs who commit to these funds are not always pleased to see the fund size balloon, because they suspect that the extra capital may lead the GPs to deals of a size and nature in which they have less experience. On the other hand, when fund sizes are kept in line with targets despite huge LP demand, many LPs complain that they aren't given the **allocations** to the fund they had hoped for. In these cases, GPs like to highlight the considerable restraint they exercised while huge capital commitments were being dangled in front of them.

Private equity funds are restricted to individual and institutional investors of a certain wealth level. These are called **accredited investors**. In the US, a section of the securities code prohibits GPs and other raisers of private funds from generally advertising or soliciting investments. Many GPs and their lawyers interpret this to mean that no mention of the fundraising should appear in the press, if possible.

Most limited partners have earmarked a certain percentage of their overall investment capital to private equity funds, and some have dedicated teams of professionals to monitor existing commitments to GPs, to deal with all the capital calls and distributions, as well as to evaluate new opportunities. Many also employ consultants, sometimes called **gatekeepers**, to help them manage their portfolios of interests in private equity funds. The private equity advisory business is booming and getting bigger. Some advisors have **discretion** to make commitments to new funds without the approval of their LP clients, and other relationships are **non-discretionary**, meaning the advisors need some form of approval from the client in order to make a commitment to a fund (advisors prefer discretionary accounts).

Some advisors will set up **separate accounts** for their clients to invest in the private equity asset class. Other advisors specialise in **co-mingled accounts**, commonly referred to as **funds of funds**. Funds of funds have become among the most important sources of capital to private equity funds. These are usually limited partnerships that in turn commit capital to private equity limited partnerships. They appeal to investors who perhaps do not have enough capital to meet **minimum commitments** required by large private equity funds (which can be as high as $25 million or more), as well as to investors who lack the expertise to select and monitor private equity fund commitments.

A good fund of funds manager and/or advisor must be able to demonstrate:

- **Access** – Professional managers of capital earmarked for private equity funds will claim to have relationships with experienced and successful general partners. They will claim these relationships allow a client access to investment opportunities not available to others.
- **Screening skills** – Private equity funds of funds and advisors will claim to be able to perform meaningful due diligence on managers of private equity funds in order to ascertain which fund managers stand a chance of performing well going forward. Often a strong track record is the best predictor of future success, but as stated above, it is difficult to measure performance halfway through a private equity fund's life, and so funds of fund managers and private equity advisors must make assessments of interim performance. They must determine who has been smart and who has been merely lucky.
- **Allocation skills** – Depending on a fund of funds' strategy, it will offer an expertise in building a diversified portfolio of private equity fund interests for a client. This is sometimes based on a view of broader market opportunities and cycles as much as it is on the underlying skills of the chosen GPs.

Sometimes private equity advisors will pool together the commitments of a number of smaller investors in order to commit to a single fund. These are called **feeder funds**.

Limited partners today have a greater ability to make **co-investments** alongside the GPs directly in deals. This means that in addition to having capital called down through the limited partnership to fund an investment, the LP essentially "doubles down" with an additional direct equity investment in the company. Some GPs charge fees and a watered-down version of carried interest on co-investments, some do not. LPs like co-investing because it gives them greater exposure to certain deals. Many GPs welcome LP co-investment because it allows them to do larger deals without hitting up against the diversification clause in the partnership agreement. Some LPs complain that GPs do not grant enough meaningful co-investment opportunities, and some GPs complain that few LPs have the wherewithal to quickly evaluate and act on co-investment opportunities.

When a limited partner commits capital to a private equity fund, it may not back out of its commitment or otherwise pull out of the fund. Failure to transfer capital when the GP requests it results in a **default**, which may carry with it a severe penalty imposed at the discretion of the GP.

But because the circumstances and appetites of LPs do change over the years, private equity has seen the development of a robust **secondary market** for interests in private equity funds. With the GP's permission, an LP may sell its interest in a fund to another LP. Several private equity firms exist that specialise in secondary transactions. In many cases, one LP will sell its interest to another LP in the same fund, or to a new LP that wants exposure to the GP in question. It is tricky to arrive at a value for a private equity fund interest. Usually the value of several underlying, unrealised investments must be taken into account, together with the expected future performance of the fund. An LP that has entered a private equity fund through a secondary transaction becomes responsible for honouring all future capital calls made by the fund's GP, but if the GP in question has proven to be inept at private equity investing, that commitment can be viewed as more of a liability than an opportunity.

Section 5
Private equity deals

Private equity can mean investment in private companies in all sectors of the economy, in any geography, in any stage of growth, using any strategy and deal structure. There are private equity firms that specialise in very narrowly defined strategies. For example, one firm may only invest in the buyouts of small, retail-sector companies based in Canada. Some firms claim to be entirely **opportunistic**, with a mandate to do any attractive deal, anywhere, of any size.

The vast majority of private equity deals involve the investment of capital in a private company in exchange for an equity stake in the company. Some firms, primarily **mezzanine debt** specialists, make loans to private companies, often in conjunction with an equity infusion.

A key ingredient to today's private equity deal is the granting of **equity incentives** to the senior management within the portfolio companies. Most private equity deals involve senior management either buying or being granted options to receive a substantial percentage of a company's equity, which can turn into a fortune when there is a liquidity event, or, by contrast, cause great personal financial pain if the company fails. Equity incentive schemes fall under the much-ballyhooed notion of alignment of interest in private equity, where all parties, from the corporate management to the GPs to the LPs, are all highly incentivised to root for the increased value of the investment.

There are as many **investment styles** in private equity as there are firms. Below are very broad descriptions of basic private equity strategies. Many firms will pursue some version of these strategies, but with some specialisation around size of deal, geography and industry sector.

- **Leveraged buyouts** - When one reads the words "private equity" in the media today, the term is usually referring to leveraged buyouts, which have captured the attention of the world because of their increasing sizes, debt levels and famous corporate targets.

In a leveraged buyout, a private equity firm acquires a company in much the way that a person buys a house – by using a certain amount of equity and borrowing the rest. The leverage (debt) is an attractive component of the deal because it can amplify the returns generated by the investment. But increasing the leverage in a deal also increases the risk that a company will go bankrupt and wipe out the investment.

To use an example, in an "LBO", a private equity firm may agree to buy a company for a total of $1 billion. The firm may draw down $200 million in equity from its fund, and then secure the additional $800 million in debt from one or more lending institutions. If things go according to plan, the portfolio company itself services the loans with the cash flow from its operations. Buyout firms have historically therefore been attracted to companies that have strong cash flow. Because of the leverage applied, if the buyout firm in the example above sells its portfolio companies several years later for a total of $1.2 billion, it has essentially doubled its money. The firm receives back its $200 million equity investment as well as an additional $200 million. In addition, the company may have paid down, say, $200 million in debt, meaning an additional $200 million in proceeds goes to the fortunate private equity firm.

Buyouts typically see the private equity firm take a **majority stake** in the company, which usually means the private equity firm has a **control position**. Control is deemed advantageous because it means the private equity firm can force change, whether it be altering the strategy of the company or replacing members of the management team. This ability to effect change in a portfolio company is one of the key selling points of the private equity asset class, and allows many GPs to describe themselves as **active investors**, as opposed to passive.

Many buyouts involve the acquisition of companies that are already private. But many buyouts, and certainly the largest buyouts, tend to be **privatisations** of publicly traded companies. In these cases, the senior executives of the target corporations usually work with the private equity firms at presenting the case for the privatisation, while being careful to convince shareholders and regulators that the corporation is going private at a fair and competitive valuation.

The dynamics of the buyout market are highly dependent on the debt markets. When lending institutions have a large appetite for risk, as they did at the beginning of 2007, private equity firms can secure very generous levels of debt financing, measured in multiples of a company's earnings. In the 1980s, some buyout deals were completed where lenders agreed to lend 100 times a company's earnings. At the beginning of 2007, some buyout deals were getting completed at debt levels of as much as 10 times EBITDA (earnings before interest, taxes, debt and amortisation), still high by historic standards.

In the early part of the 2000s, following the telecom and internet market crash, GPs complained that banks and lending institutions had become overly conservative, not willing to provide debt financing to leveraged buyouts at the levels enjoyed by GPs in the previous years.

Where debt financing is not as available, GPs intent on getting leveraged buyout deals done need to inject more equity into a deal. So perhaps a $1 billion LBO deal might in less heady times require a GP to use as much as $500 million in equity. Once banks loosen up several years later, the private equity deal sponsors are able to refinance deals at more attractive terms.

In large or complex leveraged buyouts, private equity firms will sometimes partner with other private equity firms to share capital and expertise. Sometimes buyout firms will partner with corporations on these investments, or with their own limited partners.

Where debt financing is not as available, GPs intent on getting leveraged buyout deals done need to inject more equity into a deal.

- **Venture capital** - Venture capital deals almost exclusively involve firms taking equity stakes in young companies, many of which do not have proven business models, or even revenues to speak of. Where buyout firms typically look for target companies with predictable cash flows, venture capital investors look for companies that have potentially revolutionary technologies or business methods, which offer the potential for enormous returns if the business plans prove successful.

The venture capital market divides target companies roughly by stage of development. **Early and/or seed-stage** companies require mere "seeds" of equity to get going – it could be two guys in the computer science department at a university who have nothing more than an idea and a few lines of code. Some venture capital firms only invest in a company if it has hit some verifiable business milestone, such as having a product on the market, or having a certain amount of revenue. Some venture capital firms, typically with relatively large funds, look for rapidly growing companies that already have profits but need a large amount of capital to get to the next stage of growth.

The earlier the stage targeted, goes the conventional wisdom, the higher the risks and potential rewards. Unlike buyout funds, it is considered acceptable for the average venture capital fund to have several investment failures. But among the investments that prove profitable can be some huge winners, like Google, although this is an extreme example.

Venture capital firms often invest in syndicates alongside each other in order to spread risk and share opportunities and expertise.

Venture capital market research indicates that, even more so than in the buyout market, a venture capital firm's deal network can mean the difference between stellar success and abject failure. Super-connected venture capitalists tend to see the best deals, while everyone else gets the B-list ideas, some research indicates. That said, revolutionary technology has and will continue to come from surprising places, and venture capital firms that have positioned themselves to capture this overlooked deal flow are primed to benefit should the next Google come along.

- **Growth equity** - In between venture capital and buyouts is a wide space that is often called growth equity. Private equity firms in this space often have substantial amounts of capital to invest, but are willing to take a minority position in exchange for a stake in a growing company. Growth equity often does not involve any debt.
- **Turnaround investing** - Sometimes called **distressed investing** or, more pejoratively, **vulture capital**, turnaround investing is a specialised strategy by which GPs look for companies that are financially troubled. These **special situations** are deemed attractive because they hold forth the opportunity to acquire a company at a steep discount. The risk, of course, is that the troubled company cannot be turned around and sinks into bankruptcy, wiping out the private equity firm's investment. But if a GP is successful at improving the operations of a company, either through restructuring its debt, replacing management or repositioning its business strategy and assets, the upside potential can be significant.

Some firms only acquire the debt of a troubled company on the expectation that an improvement in the company's prospects will cause the price of the debt to rise. Many hedge funds are engaged in this strategy. But a strategy more akin to traditional private equity has GPs acquiring debt in a troubled company and converting that debt into a controlling equity position. Distressed specialists will be adept at navigating the debt markets and court systems, as many troubled companies are in or near bankruptcy. Distressed firms also frequently must deal with labour unions and companies in very mature and/or cyclical industries.

- **Mezzanine debt** - Many private equity firms have separate mezzanine debt funds, or make mezzanine investments out of the same vehicle from which they draw down equity capital. Mezzanine debt is subordinate to **senior debt**, which is the typically the largest and safest of the loan tranches involved in a leveraged buyout. A mezzanine loan to a private company is always at a higher rate than that of the more senior loans, but is also riskier because if the company goes bankrupt, the mezzanine lenders can get wiped out. Mezzanine debt often involves warrants, which allow the lender to convert some of the loan into an equity position in the company. Mezzanine debt funds are often limited partnerships with structures very similar to those of mainstream private equity funds.
- **Private equity real estate –** This is not so much a type of deal, but a subset of the alternative investment asset class. Increasingly, investment in property is being done through private equity funds. As with their business-focused counterparts, private equity real estate GPs tend to look for assets that can be somehow improved over the course of ownership, or which are located somewhere that increases the asset's risk profile, and therefore return potential.
- **Infrastructure** - As with real estate, the acquisition of infrastructure assets – roads, airports, ports, pipelines and the like – is increasingly being done through private equity-style limited partnerships. However, many of these funds have much longer-term investment horizons, or are so-called permanent capital vehicles, meaning that investment realisations are not necessarily pursued.

However a private equity firm invests in a company, it has an eye on eventually liquidating the investment at a profit – the exit. Private equity firms have several options for exiting a successful investment, including a sale to a **strategic buyer**, usually a corporation. Private equity firms have in recent times sold many portfolio investments to each other in **sponsor-to-sponsor transactions**, also known as secondary or tertiary buyouts . The advantage of a sale is that it very often involves a cash payment, meaning the GPs may immediately distribute the winnings to their LPs (and hopefully themselves at the same time).

Another popular form of exit is the **initial public offering** (IPO), whereby the portfolio company, or part of the company, is listed on an exchange. These exits are dependent on the mood of the public markets, but if all goes well they can lead to very high valuations. The downside to IPO exits is that private equity firms sometimes take years to sell down their position in the company, but if share prices go up in the meantime, no one complains.

In recent years, private equity firms have executed what is referred to as a **dividend recapitalisation** to achieve partial liquidity from an investment. In these deals, the GPs take out a loan against an existing portfolio company, but use all or part of the proceeds from the loan to pay a dividend to themselves. These dividends increase the debt burden on the portfolio company, but at the same time can enhance and hasten returns.

Section 6
Private equity performance

The short explanation for why the private equity industry has become so large is that a number of private equity funds have performed very, very well for their limited partners, and other institutions have become aware of this and clamoured to commit capital to the asset class.

More so than other investment asset classes, however, private equity performance is very difficult to measure and compare. The two standard views of performance are the **internal rate of return** (IRR) and **value multiple**. A gross IRR or gross value multiple relates to the performance of a fund or deal before a GP has paid itself fees. The net IRR or value multiple is the performance that the LP experiences after all the fees have been paid. It is important to distinguish between the two.

Although there are different methods of calculating an IRR, in general it represents the average annual return generated by an investment. Time matters greatly in the IRR. An investment that has doubled in value over three years will have a much higher IRR than one that has doubled in value over eight years. The value multiple is simply how much the value of equity capital has increased over a specified time period (1.2x, 3.7x, etc.).

A truism of private equity performance is that, in the end, the only thing that matters is how much money you got back compared with how much money you put in. As already stated, the returns of a private equity fund are not fully known until after the very last investment has been liquidated. This might be 15 years after the first capital call.

But the investment market demands periodic reporting, and general partners need to point to some record of investment history when they go out to raise the next fund, and this means private equity performance is and will continue to be measured in the **interim**.

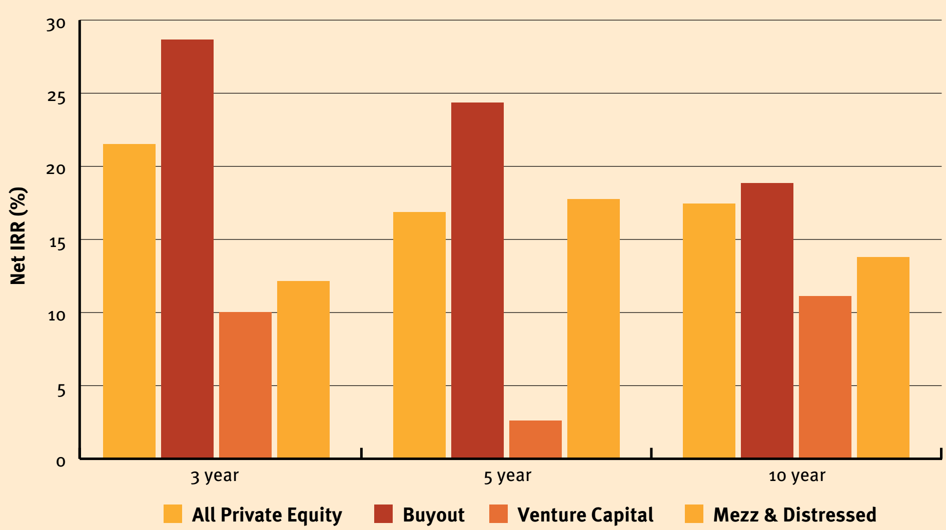
The most solid type of return is a **realised return**, which is measured based on the cash that has been returned to an LP. An **unrealised return** takes into account the estimated value of an investment prior to its exit. Because private equity is a highly illiquid investment strategy, no one knows for certain the value of a portfolio investment until it is sold to someone else. This is especially true of early stage venture capital deals, which may end up as Googles but for the time being are unprofitable little startups.

Limited partners, their overseers and auditors have for years voiced concern that GPs follow no single standard for valuing unrealised investments. Sometimes two GPs investing in the same company will report different interim values. Several private equity industry associations have proposed universal standards of portfolio valuation.

In the meantime, private equity performance can be highly subjective, making an analysis of the industry a challenging endeavour. This is made all the more so by the fact that many GPs carefully guard their performance information, as well as by the fact that the numerous private equity firms to go bust are not typically factored into aggregate performance information, a problem called **survivor bias**.

Given the importance of time on returns, as well as the fact that private equity funds often don't show any returns for several years, private equity funds are usefully divided into vintage years, referring to the year in which the fund was formed. It would be pointless to do a current, side-by-side comparison of a fund from the **vintage year** 2006 fund and a vintage-year 2000 fund, for example. Not only will a fund with a recent vintage likely not have even distributed a single dollar back to limited partners, but the peculiarities of accounting for illiquid investments often means that recent vintage funds show negative returns. This phenomenon is referred to as the **J-curve** – a reference to the initial downward slope of a line graph charting a fund's value as it moves from year to year, followed by, hopefully, a steady rise in value.

Private equity time horizon returns, as of 2007



Source: State Street Private Equity Fund Index

Many investors who have included an allocation to private equity in their overall portfolios expect private equity to outperform their stock and bond portfolios. As such, it is often said that unless private equity outperforms some public-market benchmark, like the S&P 500, private equity is not worth the hassle. Many studies have shown that in the long run, private equity, on average, has performed well.

A few rules of thumb have emerged now that several decades of relatively reliable private equity performance are available to researchers. The first is that the **top-quartile** of private equity funds tend to vastly outperform the other three quartiles, not to mention the S&P 500. This lopsided performance is even more acute in the venture capital market. It means that average private equity performance, when looked at a certain way, can appear to be attractive, but mean performance – taking into account a vast sea of mediocre, often small funds – tends to underwhelm.

A second performance observation is that private equity GPs that have done well in the past tend to do well in the future, although there are certainly no guarantees.

A third observation is that smaller funds have historically tended to outperform larger funds, due ostensibly to there being less competition for deals in more obscure markets, and therefore lower prices. But this theory has been temporarily blown out of the water by the extraordinary performance of the very largest private equity funds of the early 2000 vintages. Some analysts see a perfect storm of factors that have allowed Blackstone, Permira, TPG, KKR and the like to outperform their smaller counterparts, on average, in recent years.

Institutions that have long had an allocation to private equity, like the endowment of Yale University, have done incredibly well by it. This has led many other institutions and individuals to pile into the asset class. But Yale and many other successful LPs have benefited from access to the best GPs, who tend to reveal themselves over decades of performance. A newly minted LP may not enjoy the advantages of the more experienced LPs it seeks to emulate.

PEI MEDIA
PEIMEDIA.COM

Section 7
Recent trends in private equity

As the private equity industry has matured and grown, it has given rise to innovations and encountered challenges unimagined just a few years ago. Below are some brief notes on some of these trends:

Size. While the number of private equity firms have proliferated around the world, the size of long-established players, and the deals they do, has most captured the attention of the world. As limited partners have increased their allocations to the asset class, and as new LPs have joined in, veteran firms have been able to raise larger and larger funds. A $20 billion fund can make investments of much larger magnitude than can a $5 billion, the latter of which, five years ago, would have been among the largest private equity funds in the world. At the same time, a surge of liquidity has allowed GPs to raise hereto unheard-of amounts of debt for buyout deals. From Asia to North America to Europe, buyout deal-size records have been successively shattered, with $50 billion buyout deals no longer out of reach. Even the industry's biggest boosters worry that the risk appetite in the debt market will change. By the middle of 2007, a "correction" to the debt markets had unfolded. But the private equity funds involve typically ten-year capital lock-ups, and so record sums raised for private equity in recent years remain on call for deployment even if deal sizes decrease and leverage dries up.

Specialisation. In order to better compete, many private equity firms have created specialised industry "silos" manned with investment professionals with deep expertise in a select range of businesses. In addition, the past decade has the seen the rise of private equity firms that specialise in one particular sector – energy, for example.

Globalisation. While local private equity firms are increasingly popping up in emerging economies, the very largest private equity firms, based largely in the US and the UK, are almost all opening offices abroad, primarily on both sides of the Atlantic and in Asia. Not only do these firms recognise that compelling deals are to be done overseas, but their domestic portfolio companies increasingly need to establish global operations in order to thrive.

Convergence. Many private equity firms now manage multiple funds with multiple strategies, including debt funds, hedge funds, distressed funds, infrastructure funds and private equity real estate funds. In addition, hedge funds and other alternative investment vehicles are crossing over into private equity territory. This blurring of strategies has been a counterpoint of the trend toward increased sector specialisation.

Institutionalisation. Private equity firms were previously viewed as mere shell entities for the management of private equity funds. Now some private equity firms, through their **management companies**, have powerful franchise value and institutional-quality business infrastructures. As the headcount increases at private equity firms and founders eye retirement, there is concern that few private equity firms have solid succession plans in place. The value of the general partnerships, as well as the need to create long-term ownership structures, has led many private equity firms to sell stakes in their management companies. More recently, several very prominent firms with private equity programmes, including Blackstone, KKR and Fortress Investment, have chosen the public markets as a path to rewarding founders while ensuring a long-term capital resource for the franchise.

Disclosure. As private equity has grown in prominence, firms that were formerly highly secretive have been compelled to reveal more to the public. Disclosure is a pre-condition for going public, but even firms that are content to remain private entities are encountering pressure from politicians and regulators to be more open or have openness forced upon them. In the US, a new lobbying group called the Private Equity Council has been formed specifically to better explain private equity to lawmakers and their constituents, many of whom view buyout firms as predatory job-destroyers. In the UK, an industry panel has called for greater transparency. A wave of so-called freedom-of-information requests beginning in the early 2000s led many public-institutions that commit to private equity funds, such as public pensions, to disclose fund performance information to the public. At first GPs were outraged, but now this level of disclosure is grudgingly accepted by all but a very few private equity firms.

Tax troubles. Private equity GPs have recently been put under hot lights because government concerns over the taxes they pay, or don't pay. In several Asian countries, local politicians have decried complex private equity deal structures that allowed GPs to avoid taxes on windfall exit proceeds. In the UK and the US, a growing number of politicians have suddenly decided that the tax on carried interest is unfairly low. It is unclear what effect a higher carried interest tax would have on the market, other than make thousands of GPs very, very unhappy.

David Snow
New York, 2007
david.s@peimedia.com

The PEI Media Portfolio

BOOKS

We publish a growing series of market reports, research guides and directories providing in-depth information and analysis for various industry participants: including GPs, LPs, financiers and other advisers. These books are written by seasoned experts with input from our own editors and often include proprietary data and survey results. They offer some of the most substantive guides to key aspects of the private equity and institutional real estate markets. Some of our most popular titles include:

- The Global Limited Partners Directory
- The Guide to Distressed Debt and Turnaround Investing
- The Private Equity Factbook
- The Fundamentals of Private Equity and Venture Capital

www.PEIMedia.com/Books

CONFERENCES

PEI Media's conference division is the leading provider of annual meetings to the global private equity and real estate communities, hosting more than 16 events around the globe for senior professionals every year. Our targeted industry meetings include:

- A portfolio of annual events aimed at private equity COOs and CFOs (750+ attendees in New York, San Francisco and London)
- A series of annual meetings for private equity Investor Relations professionals (300+ attendees in New York and London)
- A group of conferences for the private equity real estate community at present including New York and London locations (400+ attendees)

www.PEIMedia.com/Conferences

DATA

PEI Data's tools are used by investor relations and fundraising professionals at the most active GPs, fund of funds providers and placement agents in the industry. These companies have found they have been able to improve the way they monitor changes and additions to the LP universe, inform the way they communicate with investors and ultimately, ease their access to capital. There's a very good chance you could do the same. Request a demonstration at:

www.PrivateEquityConnect.com/demorequest

and

www.PEREConnect.com/demorequest

PUBLICATIONS

- **Private Equity International** is our flagship publication, and probably the most widely read and recognized monthly magazine on private equity and venture capital.
- **PEI Asia** provides subscribers with news and analysis covering the deals, the funds, the firms and the people that are helping extend the reach and importance of the asset class across Asia and the Middle East.
- **PrivateEquityOnline.com** is the most widely read online publication for global private equity news and comment.
- **PEI Manager** delivers substantive commentary and guidance on all aspects of operational best practice for the private equity and venture firm.
- **PERE** (Private Equity Real Estate) offers perspective on the most pressing issues confronting those investing in assets via private real estate vehicles today.
- **PrivateEquityRealEstate.com** provides daily news coverage of the deals, firms and personalities shaping the global real estate markets.

www.PEIMedia.com/Publications