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Understanding Private Equity

an Artivest Primer | January 2019

Artivest serves some of the largest and most respected private equity firms in the world as a technology-enabled alternative investment platform. Our firm also manages proprietary private equity funds as an alternative asset manager. In this private equity primer, we provide a comprehensive overview of private equity investing, which continues its ascent to the top of the alternative investment industry. This whitepaper is provided in Q&A format and raises questions that a fiduciary or trustee might typically ask when considering an investment allocation to this asset class.

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Understanding Private Equity Investing

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Q: **What is Private Equity?**

A: Despite its aura of complexity and sophistication, few investment terms are as clear as private equity (PE). Private equity is simply a private ownership interest in a private asset, most often a company. The overarching mission of private-equity investing, like its name, is also straightforward: bring about positive change in a company that increases its value. In other words: buy, change, and sell. Value-creation activities in PE investments, called "portfolio companies," can include: financing an acquisition, taking a public company private to implement a long-term strategy, or restructuring a company's balance sheet.

Q: **Is Private Equity a New Investment Strategy?**

A: Although the private equity industry has expanded greatly over the last two decades, it is not a new endeavor. Affluent individuals and institutions have invested in private assets and entities since the industrial revolution.

In 1852, Brothers Emile and Isaac Péreire established a Paris-based private merchant bank, Crédit Mobilier, widely considered one of the world's first private equity operators. A major source of funding for Europe's economy in the mid-19th century, Crédit Mobilier provided capital to companies and major infrastructure projects.

Due to restrictions imposed under the Glass-Steagall Act in 1933, private merchant banks were unable to operate in America.[1] Wealthy families, such as the Rockefellers, Vanderbilts, and Warburgs, filled the void, making private equity their province in the early-to-mid 20th century. Laurence Rockefeller, for example, funded the creation of Eastern Air Lines and Douglas Aircraft.

The modern PE industry was largely conceived by a handful of American corporate financiers, most notably Jerome Kohlberg, Henry Kravis, and George Roberts (now known as KKR). The trio began making a series of "bootstrap" investments in family-run businesses, which faced financial and succession issues in the 1960s. KKR's acquisition of Orkin Exterminating Company in 1964 is considered the first leveraged buyout (LBO) transaction in U.S. history.[2]

In 1980, just 24 private equity firms were operating across the globe. Despite the small number of active firms, a handful of large endowments and foundations began allocating a small percentage of their portfolios to private equity in the 1980s. By 2015, just 35 years later, more than 6,600 new private equity firms had entered the private equity arena, a 109,600% increase in operators.[3] Private equity assets under management (AUM) have followed suit. As of calendar 2017, total private equity AUM stands at more than $5.2 trillion, up from $4.7 trillion in 2016.[4] Yale University, one of the earliest PE adopters, has continued its strong support of the asset class. As of June 30, 2018, Yale, which has a ~$30 billion endowment, has allocated more than 30% of its portfolio or ~$9 billion to private equity strategies.[5]

> "In 1980, just 24 private equity firms were operating. By 2015, more than 6,600 new firms had entered the private equity arena."

In calendar 2018, leading PE firms continue their search for new sources of capital—and have set their sights on the wealth management industry and individual investors. In April 2018, Blackstone, one of the industry's four largest PE firms, announced an expansion of its private wealth unit. A Blackstone spokesperson stated that half of the firm's assets may come from individual investors in the next ten years.[6]

Today, it's critical that individual investors, and their advisors, understand what private equity is and does—and what benefits it can provide to investment portfolios.

Q: How Do Investors Access Private Equity?

A: Seven primary vehicles exist to invest in private equity, as outlined below.

Private Equity Funds: By far the most popular PE vehicle, private equity funds—also known as "primary funds" or "primaries"—are pooled investment vehicles structured as limited partnerships. In early 2018, a record 2,296 private equity funds were active in the market, seeking to raise more than $740 billion, a 25% increase over 2017.[7] Private equity funds continue to dominate the marketplace as the vehicle of choice for institutional and high-net-worth individual investors.

Secondaries: The secondary market is focused on the buying and selling of investors' interests in primary fund investments, hence its name. With primary funds being illiquid and having a capital lock-up of ten years, the transfer of a limited partner's interest can be complex and take months to complete. For calendar 2017, transaction volume in the PE secondary market surged to $54 billion, surpassing the $47 billion record.[8]

Fund of Funds (FOFs): These vehicles pool capital to invest in a portfolio of five or more private equity funds. FOFs were created for capital-constrained investors, such as high-net-worth families and smaller institutions, who lack the capital to build an entire PE investment program. The FOF format provides diversification and economies of scale, but an added layer of fees. FOFs typically charge annual management fees of 1.0% and a 5.0% performance fee on gains, on top of the fees charged by private equity funds.[9] The private equity FOF industry stood at a significant $381 billion in AUM for calendar 2016.[10]

Interval Funds: Originally created in 1990, interval funds, like private equity, are not a new development.[11] An interval fund is a continuously offered closed-end fund that periodically offers liquidity or redemptions, like many hedge funds. Currently, there are 43 interval funds in existence, with PE-focused interval funds coming in at ~20% of the total.[12] Industry insiders have recently remarked that the rebirth of interval funds is creating a favorable new liquidity structure for investors and alternative asset managers.[13] Over the past year, these funds have increased their assets by more than 50% to $25 billion in assets under management, according to *Interval Fund Tracker*.

Publicly-Traded Private Equity Funds: Exchange traded funds (ETFs) and open-end mutual funds categorized as "private equity," can, in reality, only mimic the asset class. These vehicles typically hold three types of public securities to simulate the performance of PE funds: 1) Stocks of publicly-traded private equity firms, such as KKR (NYSE: KKR); 2) Stocks of public companies that may compare to private PE portfolio companies; and 3) Stocks of business development companies (BDCs), which also provide capital to private companies like PE firms. The knock on these publicly-traded PE vehicles is two-fold: sky-high expense ratios and a high correlation to small-cap value funds, rather than PE funds.[14]

Co-Investment: Considered the most complicated of the seven vehicles, equity co-investments enable qualified investors to invest alongside a private equity firm without paying the usual fees charged by a fund manager. Co-investment opportunities are typically restricted to large institutional investors who already have an existing relationship with a private equity firm. According to a recent *ValueWalk* study, more than 80% of LPs reported better performance from co-investments as compared to traditional commingled fund structures.[15]

Direct Investments: The overwhelming majority of PE investors don't possess the advanced capabilities and resources required to invest directly in portfolio companies. Direct investing, like co-investment, is reserved for institutions looking to secure a larger share of PE profits by managing their own in-house private equity investment team. Although many institutions have intentions of building their own direct PE programs, few have done deals on their own. Of the 308 direct deals completed by limited partnerships in 2017, only 62 or 20% were solo deals, where the LP invested alone, without a co-investor.[16]

Q: How Do Private Equity Partnerships Work?

A: Private equity funds are generally structured as limited partnerships. The general partner (GP), most often a private equity firm, is the PE fund manager tasked with managing the operations of the fund and selecting fund investments, called "portfolio companies." The limited partners (LPs) are the fund's investors. Typically, a private equity firm, such as KKR, will manage a series of individual private equity funds and will attempt to raise a new fund every three-to-five years as the prior fund becomes fully invested.[17]

As limited partnerships, private equity funds are governed by a limited partnership agreement (LPA), which outlines important terms for the fund's investors, including:

- **Partnership Terms**: PE funds have a fixed-life of typically ten (10) years and invest the bulk of their capital in the first three-to-five years of that term, typically called the "investment period." The calendar year that a fund begins investing in portfolio companies is known as its vintage year.

- **Management Fees**: Limited partners make annual payments to the general partner to pay for investment operations. This payment is typically 2.0% of the fund's committed capital. Committed capital is the amount of money that a limited partner commits to invest in a private equity fund.

- **Distribution Waterfall**: This term captures how capital is returned to investors after a liquidity event, such as an initial public offering, a merger, or an acquisition. The waterfall details a "hurdle rate" or preferred rate of return required, before a fund manager is awarded a performance fee called "carried interest." Primaries typically require a hurdle rate between 6% and 10% (most often 8%) and award GPs a 20% performance fee or share of the profits after that return is reached.[18] Distributions typically occur during the "harvest period," when the fund manager sells the fund's stakes in portfolio companies or a liquidity event occurs.

- **Restrictions on the GP**: The GP has full discretion to operate the fund and select investments. The LPA, however, generally details certain restrictions, which may limit the geographic focus, size, and timing of investments.

- **Transfer of Interest**: PE funds are not generally intended or organized to be traded, but ownership interest can be sold and transferred in the secondary market. Typically, this transfer must receive the consent of the PE fund manager.

Q: What are the Principal Private Equity Investment Strategies?

A: Global consulting giant McKinsey tracks seven private equity strategies and their current assets under management on an annual basis.

1. **Buyouts**: A focus on value creation in cash flow positive companies.
2. **Growth Equity**: A focus on operating companies requiring capital infusions.
3. **Infrastructure**: A focus on public works, such as bridges, tunnels, and toll roads.
4. **Natural Resources**: A focus on real assets, such as oil and precious metals.
5. **Private Debt**: A focus on the debt structure and financing of a company.
6. **Real Estate**: A focus on property development and redevelopment.
7. **Venture Capital**: A focus on new and rapidly growing companies.

While McKinsey tracks all seven strategies, it notes that only three of these disciplines are truly “private equity” and focused on private-company investing. These are venture capital, growth equity, and buyouts. The following is a brief overview of these three “core” PE strategies, which run across a private company’s lifecycle.

Venture Capital (VC): VC funds invest in start-ups and early-stage companies with high growth prospects. They take a minority stake in a portfolio company, unlike buyouts, leaving control with a company’s executive team. The most risk intensive of all PE strategies, VC portfolio companies often possess little or no track record. Venture capital can, however, deliver spectacular rewards. In 2012, Sequoia Capital made a $60 million investment in messaging service WhatsApp. In 2014, WhatsApp was acquired by Facebook and Sequoia’s stake soared to $3 billion, a 50X return on its investment (ROI).[19]

Growth Equity: The second stop on the private company continuum is growth equity. More mature than VC-funded companies, growth equity companies generate revenue, but don't have sufficient cash to fund major expansions or retire debt. These companies may not be cash-flow positive at the time of acquisition, but they are expected to reach that level during the harvest period. Although growth equity is a more conservative strategy than venture capital, it can also generate outsized returns. In 2005, DoubleClick was acquired by two growth-equity firms, Hellman & Friedman and JMI Equity. Two years later, DoubleClick was sold to Google for $3.1 billion in cash, generating an immense ROI for Hellman and JMI.[20]

Buyouts: Also known as leveraged buyouts or LBOs, buyouts focus on value creation in mature, cash-flow positive companies, ranging in size from middle market to mega buyouts. The crux of the buyout strategy is that a PE fund assumes full control of the company, utilizing some equity, but primarily debt. In 1986, KKR completed a friendly buyout of Safeway, making an equity investment of just $129 million and utilizing debt for the remainder of the $5.5 billion acquisition. In 1990, Safeway was taken public and KKR earned $7.2 billion for a 55X ROI.[21]

Q: What is the Role of a Private Equity Investor?

A: Allocating to a private equity fund entails four phases for investors.

1. **Qualification**: Due to the unregulated nature of private investing and private placements, the U.S. Securities and Exchange Commission (SEC) requires that investors meet certain income or asset requirements to invest in private equity funds. Investors must qualify as either an "accredited investor" or a "qualified purchaser." (These two terms are defined further in this paper's glossary.)

2. **Commitment (a.k.a. the Commitment Amount)**: The limited partner signs a legally binding agreement to provide a set amount of capital to a private equity fund over its investment phase, which is usually called down in three-to-five years.

3. **Drawdown (a.k.a. Capital Calls)**: The GP or fund manager "draws down" or "calls" the investor's committed capital in specific increments, as the general partner finds attractive investments, typically with ten days of notice. This typically happens during the investment period of the private equity fund.

4. **Distributions (a.k.a. the Harvest Period)**: The investor receives "distributions" or "returns" as the manager "exits" investments through a liquidity event. These distributions are typically paid to the investor as cash, but can be utilized to offset future drawdowns or capital calls.

Q: What is a Typical Allocation to Private Equity?

A: According to Cambridge Associates, eVestment Alliance, and Preqin, the average institution investing in alternative investments has a target allocation for private equity that runs between 6% and 13%. This range represents the target for an entire PE investment program, not for a single investment. As for individuals investing in private equity, the optimal percentage depends on one's long-term investment goals, and even more importantly, liquidity needs.

Q: How Do Private Equity Fund Managers Price Investments for Acquisition?

A: The acquisition price of an investment is based on a multiple of the company's historic income. The income standard utilized is referred to as gross earnings or EBITDA (an acronym for earnings before interest, taxes, depreciation, and amortization). Private equity multiples are highly dependent on the portfolio company's industry, size, and the availability of debt financing.

Q: How Does a Private Equity Fund Exit an Investment?

A: A private equity fund's ultimate goal is to exit or sell its investments in portfolio companies for a significant return. There are four common options for exit: 1) An initial public offering of the privately-held portfolio company; 2) Sale of the portfolio company to a strategic acquirer through a merger or acquisition (M&A); 3) Sale of the interest in the portfolio company to another private equity firm; and 4) A preferred dividend provided by the portfolio company to the PE fund to repay the entire capital investment, often financed with additional debt financing secured by the portfolio company.

Q: **How Do Private Equity Firms Generate Returns?**

A: The method for generating positive returns is to increase enterprise value. While there are many avenues to pursue positive change in a portfolio company, the same cannot be said of increasing enterprise value or EV. Just four factors impact the enterprise value of a company: cash flow, costs, debt, and revenue.

Enterprise value (EV) can be described as cash flow or earnings before interest taxes, depreciation, and amortization (EBITDA), multiplied by a cash flow multiple (CFM). The simple equation created is EV = EBITDA x CFM. The equity value (E) of a portfolio company is then reached by subtracting a company's debt from its enterprise value or: E = EV – D. To generate positive returns, a private equity fund manager has just three paths: grow enterprise value, reduce debt, or both.

Q: **What Returns Should Investors Expect?**

A: As mentioned, private equity is a highly illiquid asset class. Investors seek higher returns from private equity, as compared to public equity, due to this lack of liquidity. Over its modern history, the average return requirement from institutional investors for private equity has been +3% to +5% per year over a listed equity benchmark over a full investment cycle, even after paying substantial management and performance fees.

It is important to note that historical private equity fund returns are difficult to obtain due to the private nature of these investments, along with the lack of financial and operational information available. What can be offered is recent survey results from more than 250 institutional private equity investors, as provided by alternative investment research firm Preqin.[22] For calendar 2017, Preqin found the following:

- Over a one-year period, 95% of PE investors felt their private equity fund investments met or exceeded their expectations.
- Over a one-year period, 53% of private equity fund investors plan to increase their allocation to private equity over the long term.
- Over a three-year period, 38% of PE fund investors stated their expectations had been exceeded, while 57% of PE investors said their expectations had been met.
- Looking ahead, 40% of PE fund investors expected returns in 2018 that were +4.0% or higher than a public equity index, while 35% expected returns between +2.0% to +4.0% higher than a public equity index.

Q: What are the Primary Drivers of Private Equity Outperformance?

A: Over long market cycles, academics and private equity practitioners have offered three explanations for PE's superior performance as an alternative asset class:

1. Private company managers have a far stronger motivation to achieve success. In private companies, the percentage of ownership in the hands of the operators is significantly greater than in public companies.
2. The owners of private companies answer only to their partners, without the need to meet Wall Street analysts' demands for short-term performance. In other words, owners are free to implement long-term growth strategies, without any impact on their stock price.
3. Private equity is an uncommonly active investment discipline, which rewards a hands-on approach, operating and investing expertise, and a track record of success.

Final Considerations for Private Equity Fund Investors

Investing in private equity funds differs greatly from investing in publicly-traded securities, such as mutual funds or stocks. Below we detail six key considerations that should be contemplated by prospective investors.

1. **Alignment:** Private equity investors have a greater alignment of interests with private equity fund managers, due to the amount of capital being invested, along with financial incentives provided to the fund manager through carried interest (the performance fee). This degree of alignment is difficult to achieve in public equities.

2. **Control:** A PE fund manager has far more control over a portfolio company investment than a public stock investor. PE fund managers usually control the board of directors of a portfolio company, either independently or in concert with other private investors. This means the executive management team of a portfolio company is subject to change at the fund manager's will. A stock investors' level of influence over a public company, in comparison, is inconsequential.

3. **Fees:** Private equity funds charge higher fees than most investments, but they do so sporadically. Primary funds levy management fees on committed capital from limited partners during the investment period. After this phase, PE funds charge fees on remaining capital, rather than net asset value. Investors, of course, strive for a significant increase in value with a liquidity event, and that distribution is never subject to a management fee.

4. **The J-Curve:** In the early years of a fund, limited partners pay fees to the GP and the gross returns from the portfolio are typically not positive enough to overcome the fee burden. As a result, net fund returns are usually negative during the early years of a fund's life. In addition, certain PE investments may require early write-downs or valuations may suffer from a need to reduce cash flow. These activities can add to the fund's negative return before winners can be recognized and returns turn positive. Mapping a PE fund's return over time produces a steep upwards curve that is shaped like the letter "J."

5. **Measurement:** PE investment performance is measured by internal rate of return (IRR), while public stocks are gauged by time-weighted return (TWR). A private equity fund's drawdowns, and then subsequent returns, cause the value of a PE investment to vary dramatically during its lifespan. A dollar-weighted return measure, such as IRR, is far more accurate than TWR, as it captures the gain relative to the amount invested.

6. **Pricing:** While stocks are priced daily in the public equity markets, a private equity portfolio is valued no more than quarterly by the fund manager, using various assumptions. Once a year, an independent auditor or valuation firm, will review a PE fund's investments and provide valuations. According to the U.S. Generally Accepted Accounting Principles, the accounting standard adopted by the SEC, private equity funds generally hold "Level Three" illiquid assets. This means that a fair value cannot be determined by using measures such as market prices or models, and can only be calculated by utilizing estimates.[23]

Endnotes

7. The Glass-Steagall Act was passed by the U.S. Congress in 1933, prohibiting commercial banks from participating in the investment banking business.

8. A leveraged buyout (LBO) is a financial transaction in which a company is purchased with a combination of equity and debt. The use of debt, which has a lower cost of capital than equity, serves to reduce the overall cost of financing the acquisition. The cost of debt is lower because interest payments reduce corporate income tax liability, whereas dividend payments do not.

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Glossary of Private Equity Terms

All definitions below are based on information from Investopedia.com and Mercer.com.

Accredited Investor: Accredited investors must meet one of two income requirements, according to the U.S. Securities & Exchange Commission (SEC): 1) A net worth of at least $1 million (excluding the value of one's primary residence); or 2) Income of at least $200,000 each year for the last two years (or $300,000 combined income if married) with an expectation to earn the same amount in the current calendar year. For more information about accredited investors, please visit sec.gov.

Buyout: The acquisition of a controlling stake in a business, by targeting the debt portion of the capital structure in a target portfolio company.

Capital Call: Also known as a "call" or "drawdown," this term represents the portion of a capital commitment that a GP requests from the limited partners to fund new investments or cover operating expenses.

Carried Interest: Also referred to as "carry" or "performance fee," this is the share of private equity fund profits earned by the general partner (GP).

Co-Investment: Minority investments made alongside a private equity investor, most typically a private equity firm, in a transaction. The private equity firm involved will typically exercise control and perform investment monitoring functions.

Commitment: An amount of capital that has been committed to invest in a partnership. This capital is usually called by the general partners on a 10-day notice. Once the private equity partnership is executed, the investor is legally bound to fund these capital calls.

Distribution: A return of capital and profits to the limited partners or private equity fund's investors. Distributions are most often triggered by a portfolio company undergoing a liquidity event, such as an acquisition, merger, or IPO.

Fund of Funds (FOF): A private equity partnership that invests in other PE funds, rather than in portfolio companies. Fund of funds are an outsourced option for implementing a private equity investment program.

General Partner (GP): The private equity firm or management company, which has unlimited liability for the debts and obligations of the limited partnership and the legal right to participate in its management. The GP represents the intermediary between investors with capital and businesses seeking capital to grow.

General Partner Commitment: This term defines capital being committed to the private equity fund by the general partner. This is an important feature and benefit of private equity fund investing, as it aids with the alignment of interests between the general partner and limited partners (the fund's investors).

Hurdle Rate: Also known as the preferred return or minimum rate of return. The hurdle rate represents the specified return the limited partners in a private equity fund receive before the general partner is provided carried interest or the performance fee. Hurdle rates range from 6% to 10% with the industry average standing at 8%. Venture capital funds traditionally do not have hurdle rates.

Internal Rate of Return (IRR): This is a measurement of returns for a limited partner in a private equity fund. Internal rate of return takes into account all of the cash inflows and outflows from a particular investment, along with the residual market value of the asset.

Limited Partner (LP): An investor in a limited partnership, the most popular vehicle for investment in private equity as an asset class.

Limited Partnership: A private equity investment vehicle that consist of a general partner that manages the private equity fund, along with the limited partners that commit capital to the fund as investors.

Limited Partnership Agreement (LPA): The governing legal agreement for a limited partnership. This document specifies the rights and responsibilities of the limited partners and the general partner.

Management Fee: This is the annual fee payment due to a private equity fund's general partner. The fee is calculated as a percentage of committed capital during the investment period and a percentage of remaining capital thereafter.

Mezzanine Debt: Also known as private subordinated debt, mezzanine debt is often issued with warrants or the right to invest alongside the equity sponsor. This type of debt is most often used to finance buyouts or provide growth capital.

Private Equity: The making of equity or equity-like investments in privately negotiated transactions. Private equity has historically been a broad term that covers several investments strategies, including assets, entities, and companies. In its truest sense, it is limited to company-based investing only.

Qualified Purchaser: This is a term defined by the U.S. Securities and Exchange Commission (SEC). Investors must meet one of the four following criteria to be considered a qualified purchaser: 1. An individual or family-owned business that owns $5 million or more in investments. 2. A trust sponsored and managed by qualified purchasers. 3. An individual or entity that invests at least $25 million, either for their own accounts or on others' behalf. 4. Any other entity, if all owners are qualified purchasers. For more information about qualified purchasers, please visit sec.gov.

Secondaries: Acquiring existing interest in a private equity fund or primary fund from an existing limited partner. Secondary transactions may also consist of direct investments in private companies acquired from the original holders.

Special Situations: A catch-all category used across the private equity industry to capture investment strategies that do not fit into the buyout, growth equity, or venture capital sectors.

Venture Capital: A type of private equity investment that provides capital to new or growing businesses with limited revenue. Venture funds invest in startup firms and small businesses with perceived long-term growth potential.

Risks and Important Considerations

It is important to note that all investments are subject to risks that affect their performance in different market cycles. There are significant differences between public and private equities, which include but are not limited to, the fact that public equities have a lower barrier to entry. There is also greater access to information about public companies. Private equities typically have a longer time horizon than public equities before profits, if any, are realized. Public equities provide far greater liquidity, whereas private equities are considered highly illiquid.

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