CAIS IQ

Private Equity

Foundations of Alternative Investments

Co-authored by Mercer

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Private Equity, an Introduction

Private equity, an asset class once available only to institutional investors such as pensions, endowments and family offices, is becoming increasingly accessible to individual retail investors.

This trend comes at a time when investors are seeking greater access to alternative sources of growth and ways to diversify traditional portfolio exposures. It appears that the impetus for this shift has been provided in part by (i) slowing global economic growth as well as (ii) low expected returns in traditional asset classes, such as stocks and bonds.

While historically strong returns of private equity have attracted investors, many do not understand what has been propelling such returns.

What is Private Equity?

Private equity is often used as an all-encompassing term to describe investment in a company not listed on an exchange i.e. a private company. **Common categories of private equity include buyouts and venture capital, though it can also include growth equity, secondaries and distressed. Other forms of private investments include private credit, infrastructure and energy funds.** While investors generally associate a higher risk/return to private equity relative to public markets, each of these sub-asset classes has varying risk profiles, return dynamics and liquidity constraints which will be addressed below.

With the growth of defined contribution savings plans (401(k), 403(b), etc.) and the wealth management industry, exposure to a public company investment is common among individual investors, whether held directly or through a mutual fund or Exchange Traded Fund (ETF). Yet, during the past 20 years the number of public companies in the U.S. has dropped from a peak of around 8,000 U.S. companies listed in the late 1990s to approximately 5,000 today.[1] Many investors have increased focus on opportunities in private markets given the decline in sources of growth in traditional asset classes such as public equities.

Possible reasons that help explain why companies stay private can include a preference to raise both equity and debt capital in the private markets, to avoid the more heavily regulated public markets, and the ability to finance expanding operations at more favorable rates or retain greater control. From the investor's perspective, with less regulation and more internal control comes potentially greater risks.[2]

While the investments are less liquid than public holdings, private equity investors expect to receive incremental returns above public market results. This comes in part from general partners' ability to transform business and create value.

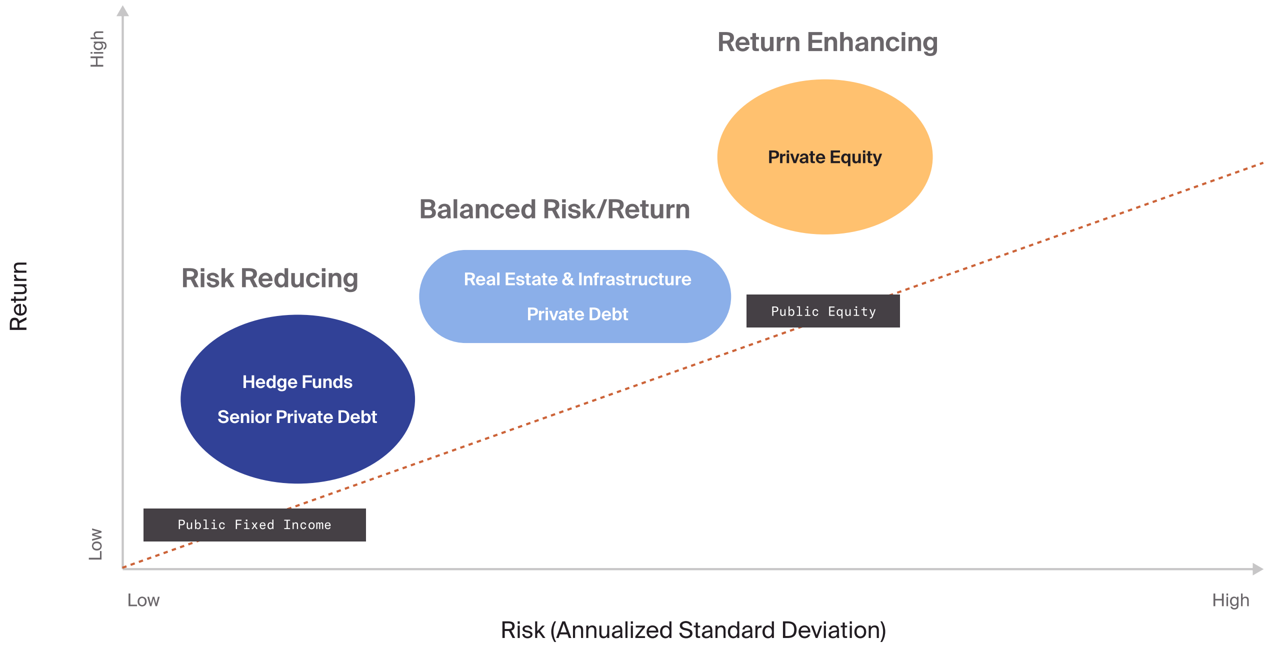
Fund raising data for the overall global private equity industry (as demonstrated in Figure 2) indicates robust activity, with $600-700 billion of capital raised annually for the last five years through 2020. While the number of funds raising capital has declined from 2017 through 2020, the average capital raised per fund has increased. Put another way, fewer funds are raising more capital on average.

[1] The Financial Times, The Incredible Shrinking Stock Market, 26 June 2019.

[2] Preqin, Private Equity & Venture Capital, 2021.

FIGURE 1

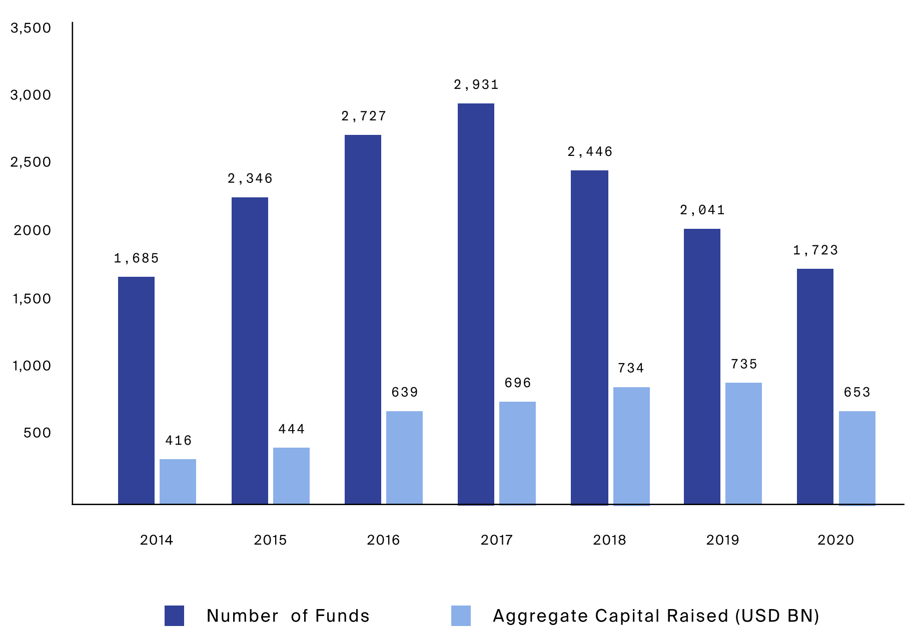
Understanding Risk and Return for Alternative Investments



Mercer. For illustrative and educational purposes only. Does not reflect returns on actual investments.

FIGURE 2

Annual Global Private Equity Fundraising



Source: Preqin

Understanding the Different Private Equity Categories

Private equity covers a variety of different categories. Individual fund managers may focus on one or more of these and typically invest across industries or specialize within an industry. The most prevalent categories include:

- **Buyout:** Buyout, the largest category,[3] is often referred to simply as private equity. Buyout funds vary in size and scope and pursue several underlying strategies. A common theme among buyout funds is the pursuit of a controlling or majority ownership of a target portfolio company. GPs may target existing private companies or seek to take public companies private. Buyout funds are often categorized by the size of the fund, which usually correlates to the market capitalization of the companies they invest in. Small-market funds are typically less than $500 million, mid-market funds typically range from $500 million to $2 billion, large-market funds range from $2 billion to $5 billion, and mega-market funds are larger than $5 billion.

- **Venture Capital:** Venture investments are generally made in new and disruptive companies across industries but are typically concentrated in technology or healthcare.[4] Venture investments can be further broken down as angel, seed, early-stage, late-stage, and pre-IPO. Each stage offers different risk and return profiles based on the size and revenue/profitability of the company. Venture is typically considered the highest-risk, but potentially higher-return investment[5] within the private equity asset class.

- **Growth Equity:** This category is characterized by funds that seek to invest in private companies that generally have more established businesses than venture capital stage companies, but greater growth potential than those in the buyout sphere.[6] Such companies may or may not be profitable, but typically have an established revenue base. Such companies may be founder-owned and in need of capital for growth, or to pursue an acquisition strategy. Growth equity investments are often made in minority ownership positions to ensure alignment with the business founder or existing management.

- **Secondaries:** Secondary investments are made by buying the LP interest of an existing private equity fund from another investor. Typically, an existing investor in a private equity fund is seeking liquidity via exiting prior to the end of the fund's term and will engage a secondary buyer to purchase their LP interest. Such transactions are usually highly negotiated and may occur at either a discount or premium to the net asset value of the investment, but typically are acquired at a discount reflecting the illiquidity of the investment.[7] This is typically determined by the underlying investments as well as the seller's liquidity needs. Secondary funds are sometimes used to gain access to a diversified pool of private equity funds that are already later in their life – either in terms of the investment or harvesting phase. This feature has the potential to dampen the impact of the J-Curve.

- **Distressed:** Distressed funds invest in companies or situations that are financially or operationally challenged, and can invest across the capital structure, depending on the specifics of the situation. An example would be making debt investments that convert to equity during a bankruptcy proceeding. Through this, the GP will seek to leverage operational and financial

[3] Ibid.
[4] Pitchbook, Emerging Technology Indicator, 2021.
[5] Ibid.
[6] Bain, Global Private Equity Report, 2019.
[7] National Bureau of Economic Research, The Liquidity Cost of Private Equity Investments: Evidence from Secondary Market Transactions, 2016.

support to either restructure or eventually turn the company around.

- **Infrastructure & Energy:** Certain private investments will specialize in infrastructure assets, such as toll roads, power plants and telecommunications, or energy assets, such as pipelines and refining facilities. These investments can vary in terms of risk and return profile with opportunistic investments sitting at the higher end of the risk spectrum compared to the lower risk associated with core type assets.

Core Foundations of Private Equity

The Structure & Phases

Private equity funds are typically structured as **limited partnerships** where the **general partners ("GPs") generally oversee the investment of the fund's assets**, manage the day-to-day operations of the fund, and **serve the interests of limited partners ("LPs") that supply capital.** LPs typically seek to benefit from the skill and expertise of the GP in not only selecting good investments, but also in providing incremental insights to company management to restructure and improve operating performance. For the life of the investment, **the LP is generally considered a passive, or silent partner**, having neither responsibilities beyond the capital it commits nor control over the timing of the investments or distributions.

There are several stages in a life of a private equity fund. The initial phase typically begins before the term of the private equity fund commences and is generally known as the **Fundraising Period**. This is the time period where the GP raises capital from investors, where limited partners make capital commitments to the fund. Depending on the Fund terms, a Private Equity fund can typically start the Investment Period after it has had its first close and received its first round of capital commitments from limited partners. Therefore, the fund can begin making investments and thus the Fundraising Period can overlap with the Investment Period.

During the **Investment Period**, the GP calls the LP's capital through what is known as a capital call. Capital is called as the GP identifies attractive investment opportunities in portfolio companies. Capital is typically called fractionally over time and is usually done over several years. The Investment Period is usually limited to a finite period of time as determined by a Fund's legal documents. Once the required capital has been called and deployed into portfolio companies, the fund then enters the Harvest Period.

The **Harvest Period** typically overlaps with the Investment Period. The focus is on growing the fund's investments and ultimately, seeking to exit at a profit. Additionally, during this time period, the GP exits all investments and returns capital to investors in the form of a distribution. Distributions are how capital is returned to limited partners in a private equity fund. Unlike other alternative investments, such as hedge funds, where investors can generally direct the sale of their investment and receive the proceeds, **private equity investors receive their capital only when the GP decides to make a distribution.** As illustrated in Figure 3, distributions may be made over several years. Investors commonly do not have positive returns from the investment for several years, which is referred to as the J-Curve.

Typically, private equity funds are structured as **closed-end vehicles** with a life, or term, of at least 10 years. Some include several one-year extension periods that provide the GP with flexibility around the exit timing of investments. General partners have flexibility on when the term of the private equity fund begins. However, usual events where the term commences are at the fund's first close, final close or when the fund makes its initial capital call.

The J-Curve

The J-Curve is a feature common to private equity investments, though often poorly understood. Not all private investments will follow the J-Curve, but many investments have seen a similar trajectory. As Figure 3 shows, capital calls in early years of the investment produce negative cash flows. In addition, negative returns are common as management fees are paid without seeing a return on investment. This may take several years to turn positive as underlying investments are marked up to their current value or gains realized through exit transactions.

Three reasons for this "J" trajectory include:

- **Management fees and expenses generally occur during the investment period and are greater than early investment returns.** They impact the depth and duration of the J-Curve. Since management fees can be charged on the entire committed capital value, regardless of whether it has been called for or not, there is a negative cash flow associated with these charges. Additionally, certain expenses incurred by the GP to source and close deals are often borne by the fund.

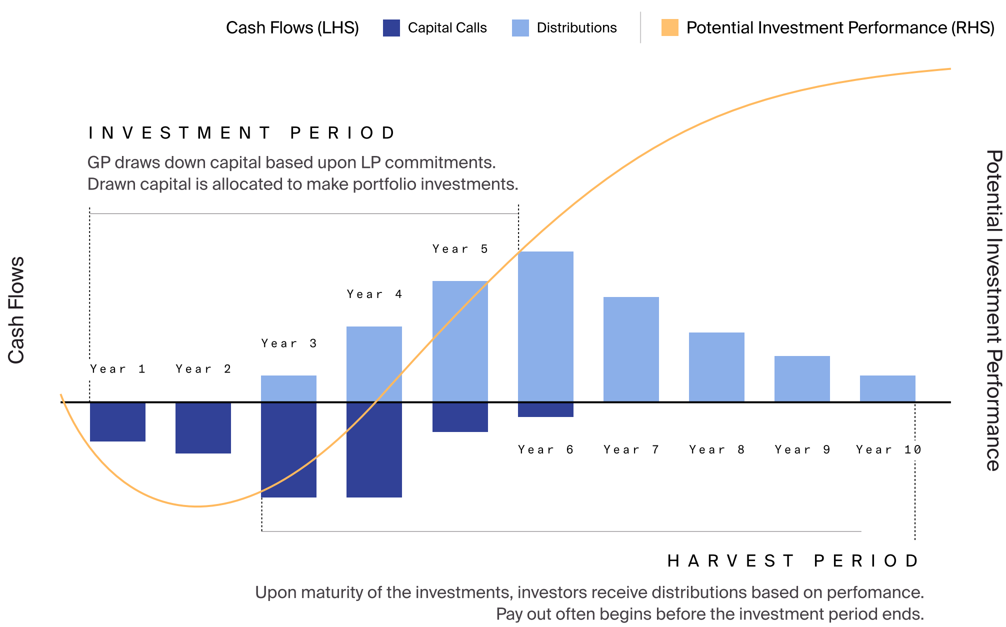
- **GPs typically write off non-performing assets when they are identified, sometimes redeploying the capital into other opportunities.** This can negatively impact performance in a fund's early years.

- **Conservative managers are generally quick to write down underperforming investments, and they can also be slow to mark investments up.** Sometimes managers are slow to adjust values leading to valuations that do not reflect volatility.

The J-Curve effect is a mostly unavoidable feature in the structure of most private equity investments and is accepted as part of the return experience by long-term investors in the asset class. Educated investors in private equity understand the need for patience with early reported returns that are not indicative of potential long-term success from the investments.

FIGURE 3

The J-Curve



Source: Mercer. For illustrative and educational purposes only. There is no guarantee that any private investment will follow the sample timeline described above, and there is risk that a private investment may never generate positive returns.

Potential Value Creation in Private Equity

Private equity has unique characteristics and features that help GPs to add value.

- **Long-Term Investment Horizon:** Investments in private equity are typically 3 to 7 years, while the life of the fund is generally 10 years or more. This is reflective not only of the time it takes to source investments, but also the time necessary for a GP to add and unlock value within each portfolio company as part of their investment strategy

- **Active Management:** Private equity is inherently an actively managed strategy. Managers may seek control or minority positions within a portfolio company. Typically, they seek voting rights or board seats and may even seek to add value through strategic, operational, and financial improvements. This can include adjustments to the business's strategy, introducing institutionalized processes, supply chain management, debt restructuring, or even changing the management team.

- **Proprietary Deal Sourcing:** Private equity managers often look to build teams with extensive networks within their target industries in order to source deals at attractive valuations. These networks can also serve as valuable sources of consultants, executives, and board members for portfolio companies. In certain circumstances, a number of private equity managers may group together in a 'club deal' to acquire larger companies, and to contribute differentiated perspectives that support the new portfolio company.

Realizing Value Through an Exit

Once value is created, it needs to be realized through an exit transaction i.e. the portfolio company needs to be sold. Private equity funds can exit their holdings in portfolio companies in several ways. The most well-known, but not necessarily most common, is to **take the company public via an Initial Public Offering ("IPO").** It is more common, however, for funds to **seek new financial or strategic buyers who want to buy the portfolio company.** The management team may also wish to **acquire a greater percentage of the company from the private equity manager through a management buyout ("MBO") or through a leveraged recapitalization,** whereby a company will use debt to buy back equity.

Noteworthy Risks of Private Equity

- **Illiquidity:** Private equity investments are generally illiquid for long periods of time. The GP controls the investment decisions and an LP may only be able to exit their partnership interest in a secondary market that may have few, or no buyers, or at a discount to stated value. Investors may expect consistently higher returns, or an illiquidity premium, to compensate for the increased risk of not being able to easily enter and exit the partnership, but these returns are not guaranteed.

- **Volatility:** Private equity is often misunderstood to have low volatility, a standard measure of risk in financial assets. This misconception is due to the infrequent changes in the valuations of the underlying assets as well as the fact that private investments are not regularly valued in trading markets such as the public equity markets, but are valued periodically by the owners of the company. It is important to understand that private equity is not a low risk investment and may be highly volatile and risky.

- **Business Risk:** A private equity investment can occur throughout a company's life, from the initial development of a business to its operational and financial decline. In a company's early stages, usually when a venture capital investment would occur, there is business risk regarding whether or not a business will be viable or competitive. In a company's later stages of development or maturity, a company may struggle to service the debt needed to complete a buyout transaction. Finally, during a company's decline when a distressed investment may occur, a company may not be able to successfully restructure and emerge from bankruptcy.

- **Lack of Control:** LPs do not have control over the investment decisions or the timing of when the GP calls capital. Given this, the skills and ability of the GP to execute on the stated investment strategy and to create value for portfolio companies need to be considered.

Allocating to Private Equity

Diversification

Many believe that diversifying private equity investment exposures is prudent and an important part of a successful investment program. Three key areas to diversify include:

- **Managers:** Investors should allocate to multiple managers given the active management risk associated with private equity. This is especially important with private equity, which can have material performance dispersion between the best and worst performing funds.

- **Strategy:** Including a variety of private equity funds (e.g. buyout, growth equity, distressed, venture) diversifies investor exposure, providing various return drivers and return profiles.

- **Vintage Year:** Investors should consider vintage year diversification. Vintage year can be classified as either the year the fund held its final close, or the year the fund made its first investment, putting money to work over multiple vintages. Given the long-term nature of market cycles that are typically characterized by different stages that impact performance, allocating to private equity over multiple years potentially mitigates risks due to market cycles and the timing of both entry and exit from private equity funds.

Manager Dispersion

It is important to try to identify and allocate to the best managers within private equity due to the large performance dispersion between the best and worst managers.

Private equity managers of competitively performing funds have in many cases persisted with strong results in follow-on funds.[8] This dynamic creates significant investor demand for the top performing managers, often making it difficult or impossible to access due to limitations on a fund's size. This elevates the importance of manager due diligence and the assessments of fund capacity as part of the manager selection process and making sure access exists when allocating to private equity.

Manager due diligence requires managers to demonstrate, clearly and persuasively:

1. **Experience and Resources:** Market experience, global reach and a well-resourced research team is essential to source the better opportunities.

2. **Relationships and Tenure:** Building relationships with and potentially gaining access to high-quality emerging and well-established fund managers takes time and commitment. The quality of those relationships can in some cases create access to future opportunities, particularly when the most sought after managers usually have limited capacity.[9]

3. **Operational Stability and Risk Management:** To address non-financial risk, governance and policies, systems, processes, and controls must be substantiated by an evaluation of middle and back office activities.

[8] McKinsey, A New Decade for Private Markets, 2020. Past performance is no guarantee of future results.
[9] Access to capacity constrained funds can never be guaranteed, with the decision ultimately being that of the GP.

Establishing an Allocation Strategy

Time and prudence are necessary to build a diversified private equity portfolio. Several approaches to gain the desired private equity exposure include:

- **Disciplined:** Create a capital deployment schedule that covers multiple years, and strategy types. While the timing of when a particular manager will be in the market raising capital is uncertain, the upfront focus on building a diversified structure and relying on effective manager selection will better position investors for potential success.

- **Opportunistic:** If top performing managers are chosen independent of weightings to each category or industry, and regardless of vintage year diversification, the resulting private equity portfolio may produce a less than optimal allocation, or lack diversification by vintage years.

- **Hybrid:** Some investors may look to utilize a disciplined approach to build a core allocation to private equity, while at the same time, opportunistically commit to desired strategies as satellite exposures as they become available. ■

Private Equity Terms

- **Capital Calls:** As the GP identifies opportunities and makes investment decisions, they will issue capital calls to LPs for all or a portion of their commitment.
- **Carried Interest:** A profit sharing between the LPs and GPs.
- **Commitment:** The amount of capital that each LP contractually agrees to provide to the fund.
- **General Partners ("GPs"):** The professional investment managers that run the private equity fund and manage the fund's day-to-day operations. While management fees are typically paid to the investment manager, carried interests are allocated to the general partner.
- **Internal Rate of Return ("IRR"):** IRR is a money-weighted performance measurement and commonly used to measure the performance of private equity investments because the GP controls the timing of the investments.
- **Investment Period:** The time period over which the GP can add new portfolio companies to the fund. This period varies from fund to fund. In certain circumstances, GPs can recycle an investor's capital during the investment period to enhance capital efficiency and improve returns.
- **Limited Partners ("LPs"):** The investors in the private equity fund, such as Pensions, Endowments, HNW (high-net-worth) and UHNW (ultra-high-net-worth) Individuals, and Foundations. LPs generally have no input into the investment and exit decisions. Their liability is generally limited to the amount of capital they commit or invest.
- **Management Fee:** A fee to the investment manager to provide capital to pay salaries and expenses associated with running the fund.
- **Multiple on Invested Capital ("MOIC"):** A MOIC is another common way to measure private equity return. A simplistic example would be for an investor that invests $100 into a fund and the fund later values that investor's interest at $150, or a 1.5x MOIC.
- **Preferred Return:** A minimum amount the GP agrees to pay the LP before participating in any carried interest.
- **Vintage:** Generally considered to be the year that the fund began investing capital. Vintage years are important to understand in terms of benchmarking and peer comparison given evolving market conditions over time.

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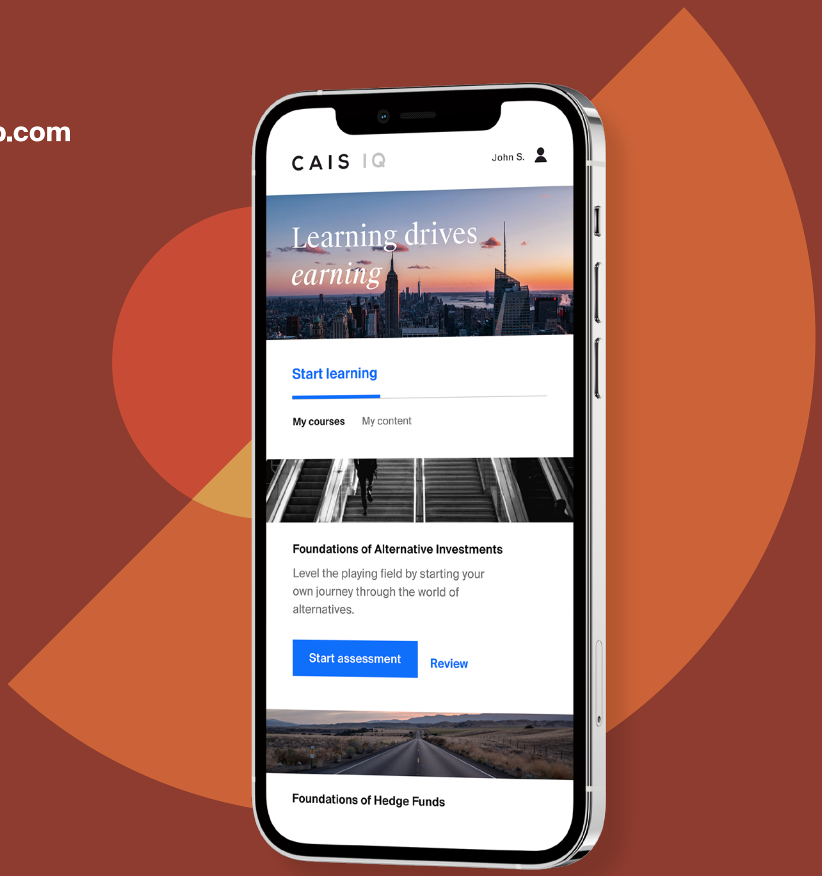

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