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EXAM PREP

SchweserNotes™

Private Markets

Level III

KAPLAN SCHWESER

Private Markets

SchweserNotes™ 2027

Level III CFA®



SCHWESERNOTES™ 2027 LEVEL III CFA® PRIVATE MARKETS

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Learning Outcome Statements (LOS)

M1. Private Investments and Structures

The candidate should be able to:

- a. contrast the features of private and public investments, and discuss characteristics of private and public markets.
- b. discuss private investment methods and structures and their uses.
- c. discuss the difference between public and private market performance, and calculate, interpret, and discuss the use of performance metrics including distributed to paid-in, residual value to paid-in, and total value to paid-in.
- d. compare the risk and return of investing in private markets and public markets as part of a strategic asset allocation.

M2. General Partner and Investor Perspectives and the Investment Process

The candidate should be able to:

- a. discuss a general partner's roles and responsibilities in managing private investment funds.
- b. discuss how private investment firms align their interests with those of their investors, and calculate, interpret, and discuss private market fund performance from an investor perspective, including management fees and carried interest.
- c. discuss favorable characteristics of private investment targets and sources of value creation in private markets.
- d. discuss the role of conducting due diligence and establishing a business plan in the private investment process.
- e. discuss alternative exit routes in private investments and their impact on value.

M3. Private Equity

The candidate should be able to:

- a. discuss private equity strategies over the company life cycle.
- b. discuss characteristics of venture capital and growth equity investments.
- c. discuss characteristics of buyout equity investments.
- d. estimate and interpret key inputs and calculate the value of a private equity investment for venture capital, growth equity, and buyout situations.
- e. discuss the risk and return among private equity investments as well as versus other investments as part of a strategic asset allocation.

M4. Private Debt

The candidate should be able to:

- a. discuss the use of debt financing in private market strategies over the investment life cycle.
- b. discuss the use of leveraged loans, high-yield bonds, and convertible bonds in private market strategies.
- c. contrast the use of mezzanine debt and unitranche debt in private market strategies.
- d. analyze private debt profiles and calculate and interpret financial ratios used to value private debt investments.
- e. discuss the risk and return among private debt investments as well as versus other private market investments as part of a strategic asset allocation.

M5. Private Special Situations

The candidate should be able to:

- a. discuss the characteristics and risks of special investment situations.

- b. discuss the features of distressed debt, financing alternatives for issuers in financial distress, and investment strategies in distressed situations.
- c. discuss the features of complex investment situations involving financial dislocation or stress.
- d. discuss the due diligence and valuation processes used to evaluate special investment situations.
- e. discuss the risk and return among special situations and compared to other forms of private debt as part of a strategic asset allocation.

M6. Private Real Estate Investments

The candidate should be able to:

- a. discuss important private real estate investment features.
- b. discuss economic value drivers of private real estate investments and their role in a portfolio.
- c. discuss the due diligence and valuation processes for private real estate.
- d. discuss the distinctive investment characteristics of timberland and farmland.
- e. discuss the risk and return among private real estate investments and as compared to other investments as part of a strategic asset allocation.

M7. Infrastructure Investments

The candidate should be able to:

- a. discuss important infrastructure investment features.
- b. discuss infrastructure investment methods and investment vehicles and their uses.
- c. discuss the infrastructure investment process over the project life cycle and the roles of infrastructure debt and equity financing.
- d. discuss the due diligence and valuation processes for infrastructure investments.
- e. discuss the risk and return among infrastructure investments and as compared to other investments as part of a strategic asset allocation.

READING M1

PRIVATE INVESTMENTS AND STRUCTURES

EXAM FOCUS

This reading is, to a large extent, a review of material covered in Alternative Investments, a portion of the Level I curriculum. Learn the terminology and definitions presented here to prepare for the subsequent readings on private investments.

MODULE M1.1: COMPARING PRIVATE VS. PUBLIC INVESTMENTS AND MARKETS

LOS M1.a: Contrast the features of private and public investments, and discuss characteristics of private and public markets.

Public investments in securities are traded on exchanges or in over-the-counter markets. In contrast, private investments are most often illiquid, not actively traded (if traded at all), and may take years before investors in private assets realize investment gains (or losses).

Private investments are often **closed end**, in that they will be liquidated over some finite horizon. The sale of private investments before liquidation may be difficult or even prohibited. Because private investments are, by definition, not traded in public markets, determining their values accurately at a point in time may be quite difficult.

While publicly traded securities can be purchased in small amounts, private investments typically require large amounts of capital and may represent a controlling interest in a company or ownership of an entire debt issue.

Note that the term *private investments* is not analogous to alternative investments. Some alternative investments (e.g., real estate and commodities)

are often publicly traded.

Figure M1.1 summarizes differences between private and public investments.

Figure M1.1: Private vs. Public Investments

Characteristic	Private	Public
Liquidity	Illiquid (sales restricted or even prohibited)	Mostly liquid (limited restrictions, if any)
Investment process	Closed end	Open end
Performance measurement	Compounded over a longer holding period	Periodic
Asset prices	Negotiated (based on estimates)	Observable and traded regularly
Management skills	Expertise needed in legal and financial analysis; experience needed in industry, management, and technical areas	Experience and expertise needed in company, industry, and financial analysis
Portfolio diversification	Dependent on uniqueness of asset type, as well as company and investment life cycle phases	Dependent on correlations of periodic returns

Private Asset Life Cycle

The **private asset investment life cycle** involves four phases:

Precommitment. Investment strategy is developed, due diligence is performed, and limited partners are solicited, leading to a commitment of capital.

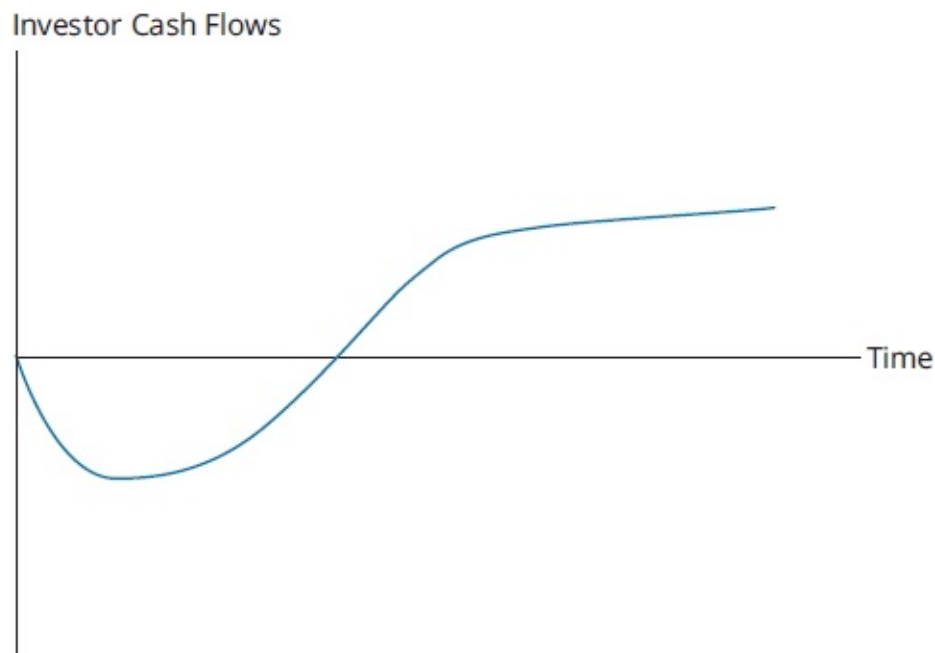
Capital deployment. Investments are selected, and committed capital is called (drawn down) by the managers.

Capital distribution. Debt is reduced (paid down), and the growth, development, or restructuring of the assets is completed.

Exit. Assets are liquidated through public or private sale or transfer.

Returns are expected to be negative in the early phases (precommitment/commitment of capital and capital deployment) and positive in later phases (capital distribution and exit). The returns reflect a **J-curve effect**, shown in Figure M1.2.

Figure M1.2: J-Curve Effect



Diversification

Private investments can provide portfolio diversification benefits. Because private investments are not traded, have both positive and negative cash flows, and are held for long periods, returns correlations with public investments are not directly measurable. However, private markets may provide diversification benefits (portfolio risk reduction) from the following sources:

- | Return dynamics of private company equity and debt over their investment life cycles, which will differ from the return dynamics of more mature public companies
- | Exposures of private company equity and debt to growth or restructuring opportunities during their life cycles, which are typically not available to investors in publicly traded securities
- | Private investment return exposures (other than equity or debt) that show different return dynamics than public investments

Private equity (PE) investments have equilibrium rates of return that are expected to be higher than those of public investments, to compensate for the greater uncertainty about their future cash flows and lack of liquidity.



MODULE QUIZ M1.1

1. Relative to an investment in a mature company's common stock, a private investment will *most likely* result in the investor having:

- A. less liquidity.
 - B. standardized terms.
 - C. established benchmarks.
2. The J-curve effect identified with successful private investments reflects:
- A. more committed capital later in the investment life cycle.
 - B. more distributed capital earlier in the investment life cycle.
 - C. greater cash outflows early, and greater cash inflows later in an investment's life cycle.

MODULE M1.2: PRIVATE INVESTMENTS: METHODS, STRUCTURES, AND USES

LOS M1.b: Discuss private investment methods and structures and their uses.

A **limited partnership** is often used as the legal structure for private investment. A limited partnership is managed by a **general partner (GP)** who controls partnership investments and has unlimited liability. The **limited partners (LPs)** provide the capital for the partnership, and their liability is limited to the amount invested.

A partnership agreement is constructed to align the interests of the GP and the LPs by sharing the profits between them. The agreement specifies both management fees and incentive fees that will be paid to the GP as compensation.

Direct Investments

A private investment is termed a **direct investment** when equity or debt is purchased without involving an intermediary. Direct investment most often requires that investors have large amounts of capital and the expertise to manage the assets purchased.

Regarding co-investment, a **direct co-investment** refers to making a *direct* purchase of assets with one or more partners, which may themselves be limited partnerships (funds). When a fund GP allows an LP to make a separate investment as a partner, directly into one of the fund's investments, it is referred to as a **limited partner (LP) co-investment**. There are benefits to the LP of investing directly alongside the GP from increased access to information, lower fees, and the opportunity to gain expertise in the management side of private investing.

Private Investment Structures

One example of a private investment structure is a **take-private transaction**, in which private investors purchase a public company and no longer list the shares (take it private). This may also be referred to as a **leveraged buyout (LBO)** when a large amount of debt financing (leverage) is used to fund the acquisition. The target company's debt often must be refinanced to satisfy existing debt covenants that include a **change of control clause**.

Longer-term financing is typically negotiated subsequent to the LBO with the issuance of medium- and longer-term debt. The debt structures used in private market transactions tend to be less standardized than those found in public markets.

Two types of loans often used in private market transactions are as follows:

Leveraged loan. This is a senior secured, prepayable floating-rate loan with possibly restrictive covenants.

Mezzanine loan. This is subordinated, typically fixed-rate debt with a seniority of claims below those of senior debt and above those of common equity. Mezzanine loans are often not prepayable, and they have longer maturities and less restrictive covenants than leveraged loans.

A **special purpose entity (SPE)** is often established for investments in real estate or infrastructure. An SPE exists as a separate legal entity created solely to finance, build, operate and sell a real estate or infrastructure asset. The investors in an SPE are not liable for the debts and contractual obligations of the SPE.

An SPE is often created as part of a **concession agreement** in which the developer of an infrastructure project is obligated to finance, construct, and operate an infrastructure asset for a specified period. As compensation, the developer receives the cash flows from operating the asset over the concession period and then transfers the asset at low or no cost (also termed a *buy-operate-transfer project*).

Angel investors are high-net-worth investors, often with entrepreneurial expertise and specialized industry experience, who provide capital for early-stage ventures (start-ups).



MODULE QUIZ M1.2

1. A private investor who participates in a mezzanine loan will have a priority of claims:

- A. below common shareholders.
 - B. above leveraged loan investors.
 - C. between senior debt and equity.
2. Which of the following statements regarding a limited partner (LP) co-investment is *least accurate*?
- A. The holding periods for LPs tend to be short.
 - B. General partners (GPs) share investment risk with the LP.
 - C. The LP has no say in the structure of the investment.

MODULE M1.3: INVESTMENT PERFORMANCE AND RETURN METRICS

LOS M1.c: Discuss the difference between public and private market performance, and calculate, interpret, and discuss the use of performance metrics including distributed to paid-in, residual value to paid-in, and total value to paid-in.

Because public investments trade in active markets, we can easily calculate returns over a given period, including any interim dividend or interest payments in the calculation as appropriate.

Compounding annual returns over a period of years produces a multiyear return. From these, we can calculate average compound annual returns to facilitate comparison with annual compound returns of other strategies or asset classes.

In contrast to those of public investments, the cash flows of private investments are often highly variable over their lives, and periodic returns based on changes in asset value are not typically available.

To calculate the value of an expected stream of cash flows that are sometimes negative and often quite variable, we often use the **internal rate of return (IRR)**. The following example illustrates the calculation of the IRR of an investment in a fund that makes multiple investments and distributions over time.

EXAMPLE: IRR for an investment in a fund

Baker Brothers, a PE firm, secured capital commitments of \$80 million for an investment fund. Capital calls for each of five investments are made over five years. Each investment subsequently makes distributions over four years. These calls and distributions are shown in the following table (in \$ millions):

Asset	Initial Investment	Cash Inflow 1	Cash Inflow 2	Cash Inflow 3	Final Cash Inflow
A1	-15	3	3	3	18
A2	-12	2	2	2	14
A3	-17	4	4	4	21
A4	-20	5	5	5	25
A5	-16	3	3	3	20

Given this information, **calculate** the IRR of an investment in the fund.

Answer:

Because the calls come one year apart, the fund cash flows are as follows:

Asset	CF0	CF1	CF2	CF3	CF4	CF5	CF6	CF7	CF8	IRR
A1	-15	3	3	3	18					
A2		-12	2	2	2	14				
A3			-17	4	4	4	21			
A4				-20	5	5	5	25		
A5					-16	3	3	3	20	
Net cash	-15	-9	-12	-11	13	26	29	28	20	21.1%

The IRR of an investment in the fund is 21.1%.

CF0 = -15, C01 = -9, C02 = -12, C03 = -11, C04 = 13, C05 = 26, C06 = 29, C07 = 28, C08 = 20, CPT IRR = 21.1.

A simpler measure of returns on a fund investment is its **return on investment (ROI)**, which is the ratio, at a point in time, of an investment's total distributions to the total amount invested. The investment holding period and time value of money do not factor into this calculation, shown here:

$$ROI = \frac{\sum \text{cash flows paid}}{\sum \text{cash flows invested}}$$

Because ROI is 1 + percentage profit, we can calculate the equivalent annual compound rate of return as $ROI^{1/n} - 1$, where n is the holding period in years. We can use this as a summary measure of investment performance. The ROI is a more accurate measure of compound annual returns for an investment with a single cash outflow and a single cash distribution at exit from the investment. This calculation is illustrated in the following example.

EXAMPLE: IRR and ROI

An investor is given an opportunity to invest \$5.2 million in a project that is expected to return \$8.3 million at the end of four years. The investor will only accept projects that exceed a target return of 10%. **Calculate** the ROI and the IRR and assess whether this investment will meet the investor's required return.

Answer:

$$\text{ROI} = \frac{\$8.3 \text{ million}}{\$5.2 \text{ million}} = 1.596x$$

$$1.596^{1/4} - 1 = 12.40\% = \text{IRR}$$

Because the IRR of 12.40% exceeds the investor's target return of 10%, the project should be undertaken.

With a private investment, committed funds are *called* (drawn down) as the GP identifies and purchases attractive assets. The size and timing of capital calls can be highly variable.

Public market conditions and the overall economic outlook will impact the timing of capital calls. When interest rates are low and appetites for risk are increasing, GPs are likely to invest capital more quickly. When interest rates are rising, risk aversion is often increasing, and committed capital is called more slowly.

The **vintage year** of a fund investment is the year that committed capital is first called. Investments with different vintage years will be in different phases of their life cycles and, therefore, subject to different risk factors.

An investor's realized return over a multiperiod horizon will be the same as the investment's IRR only when interim cash distributions are reinvested at the IRR. This is typically not an option for fund investments; cash distributions cannot be reinvested in the fund asset. An additional complication in calculating the return on a fund investment is that investment in a fund requires that committed capital be held in liquid public investments, which may return less than other, less liquid investments.

To account for these considerations and to facilitate comparisons with private market returns, analysts employ the **public market equivalent (PME)** method.

The PME method assumes that capital investments are invested in a public index fund, and that distributions are withdrawn from the index fund. The following

example illustrates the calculation of a PME return.

EXAMPLE: Public market equivalents

A €50 million PE fund with a five-year life was recently closed. The following table reflects the cash flows of the fund (in € millions), as well as a public market index and public market returns:

Year	Fund Cash Flows	Public Market Index	Public Market Return
0	−28	100	N/A
1	−22	115	15.00%
2	5	109	−5.22%
3	10	122	11.93%
4	15	145	18.85%
5	46	158	8.96%

Calculate a PME return for the fund and discuss comparing a public index with a fund's PME.

Answer:

The IRR of the fund's cash flows is 11.44%. The compound annual return for the public market index is 9.58%.

The following table shows asset values at year-end for a PME return based on the fund cash flows (in € millions):

Year	Fund PME Asset Values
0	28
1	54.2
2	46.37
3	41.90
4	34.80
5	37.92

Calculations for asset values are as follows:

- Year 0: initial investment = 28
- Year 1: 28×1.15 (public market return of 15.00%) + 22 additional investment = 54.2
- Year 2: 54.2×0.9478 (public market return of −5.22%) − 5 outflow to investors = 46.37

- Year 3: 46.37×1.1193 (public market return of 11.93%) – 10 outflow to investors = 41.90
- Year 4: 41.90×1.1885 (public market return of 18.85%) – 15 outflow to investors = 34.80
- Year 5: 34.80×1.0896 (public market return of 8.96%) = PME terminal value of 37.92

The PME IRR, based on cash flows for Years 0–4 and the PME Year 5 asset value, is equal to 8.41% ($CF_0 = -28$, $C_1 = -22$, $C_2 = 5$, $C_3 = 10$, $C_4 = 15$, $C_5 = 37.92$, CPT IRR = 8.41%).

In the example just listed, the fund's IRR of 11.44% is greater than the investment's PME return of 8.41%. This difference reflects the fact that the investment outperformed the index (which had a compound annual return of 9.58%).

One challenge of implementing the PME methodology is choosing a public market index that approximately matches the characteristics of the private market fund. An issue in comparing a PME return to a public market index return is that the public market index return is an annual compound return that does not account for the high variability of fund returns over its life.

Private Market Fund Multiples

Some simpler measures of private investment performance are based on the cumulative values of cash invested and cash distributed, and the remaining value of the fund investment at a given period.

The first of these measures is **paid-in capital (PIC)**, a measure of the extent to which the capital drawdown phase of the life cycle has been completed. This measure provides information about when a GP may need (or want) to return to the market to raise additional funds, perhaps when the distributed to paid-in gets over 75%. PIC is calculated as follows:

$$PIC = \frac{\text{capital invested}}{\text{total capital committed}}$$

The next measure is **distributed to paid-in (DPI)**, which is a ratio comparing cumulative distributions (to LPs) relative to capital invested. This “cash-on-cash” return is considered the investor's realized return, as shown here:

$$\text{DPI} = \frac{\text{cumulative distributions}}{\text{total capital invested}}$$

Another return measure is **residual value to paid-in (RVPI)**, which is the fund's net asset value (NAV) relative to total invested capital. This is considered the investor's unrealized return, as shown here:

$$\text{RVPI} = \frac{\text{NAV}}{\text{total capital invested}}$$

The **total value to paid-in (TVPI)** serves as the overall investment value to the LP and is the summation of DPI and RVPI, as shown here:

$$\text{TVPI} = \frac{\text{cumulative distributions} + \text{NAV}}{\text{total capital invested}}$$

$$\text{TVPI} = \text{DPI} + \text{RVPI}$$

A TVPI calculation that is gross of fees may also be referred to as the **multiple of money (MOM)** or the **multiple of invested capital (MOIC)**. The following example illustrates the calculation of measures of fund performance at various points in time.

EXAMPLE: Private market fund multiples

The following table reflects the NAVs, capital calls, and distributed capital of the PE4 investment fund (all data is in \$ millions):

Years	0	1	2	3	4	5	6
NAV		45	75	95	120	90	40
Capital called	-15	-25	-20	-15			
Distributed capital		0	0	0	20	25	45

Based on this data, **calculate** the following multiples:

1. PIC at the end of Year 2
2. DPI at the end of Year 6
3. TVPI at the end of Year 5

Answer:

1. PIC, end of Year 2 = $(15 + 25 + 20) / 75 = 0.80$, or 80%. Note that \$75 million is the sum of all capital calls.
2. DPI, end of Year 6 = $(20 + 25 + 45) / 75 = 1.20$, or 120%. The results show that the LPs have been paid cash distributions 20% greater than their cash investment.

3. $TVPI, \text{ end of Year 5} = (20 + 25 + 90) / 75 = 1.80$, or 180%.
The DPI component is \$45 million / \$75 million, or 60%.
The RVPI component is \$90 million / \$75 million, or 120%.



MODULE QUIZ M1.3

1. At the end of the year, the residual value to paid-in (RVPI) is equal to 40%, and the total value to paid-in (TVPI) is equal to 110%. The distributed to paid-in (DPI) measure must equal:
A. 70%.
B. 75%.
C. 150%.
2. An investment requires a single outflow in Year 0 and will produce a single inflow in Year 3. If the ROI is 1.25, the average compound annual return is *closest* to:
A. 3.75%.
B. 7.72%.
C. 8.33%.

MODULE M1.4: RISK AND RETURN FOR PRIVATE AND PUBLIC MARKETS

LOS M1.d: Compare the risk and return of investing in private markets and public markets as part of a strategic asset allocation.

Since the Global Financial Crisis of 2008–2009, rising valuations, increasing risk appetites, and relatively low interest rates have helped private markets to outperform public markets—both in terms of attracting new capital and in generating returns.

While average private market returns have outpaced public markets returns, there is significant variability in the former due to a broader range of life cycle phases and investments, as well as to differences in fund manager skills.

According to McKinsey¹, the median IRR from inception to late 2022 for PE funds with vintage years from 2009 to 2019 was 20.1%, while the average annual return of the S&P 500 Index was 11.8%. Over this period, private investment fund returns ranged from a top-quartile value of 29.8% to a bottom-quartile value of 11.4%.

Both the lack of liquidity and the greater returns uncertainty of private investments likely increased their required returns (expected returns in