Private Markets Pathway

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Learning Module 1
Private Investments and Structures

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

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

LOS: 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.

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

Introduction

Over the past few decades, institutional investors have significantly increased their allocations to private market assets to complement their public market portfolios. Initially dominated by large institutional investors such as sovereign wealth funds and endowments, private market investments now include professionally managed private investment portfolios, making them accessible to smaller institutional investors and high-net-worth individuals.

Features of Private and Public Investments and Markets

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

Public investments involve listed securities representing debt or equity claims that are regularly traded on an exchange or among dealers in an over-the-counter market. Fund managers in public markets typically invest in noncontrolling positions in mature issuers with stable cash flows. Public investments are characterized by liquidity, enabling investors to readily buy or sell positions and observe current and historical prices for securities and relevant benchmarks.

Private investments, on the other hand, consist of unlisted assets or companies that choose not to access public markets due to their size, stage of development, limited financial disclosure, or concentrated ownership. Private funds often acquire controlling or significant minority stakes held for longer periods, where value creation is a primary driver of investor returns. These investments include private equity, private debt, private special situations, private real estate, and private infrastructure.

Key differences between public and private investments include:

- **Asset prices**: Public assets have traded and observable prices, whereas private assets have negotiated and estimated prices.
- **Performance measurement**: Public investments use periodic measures, while private investments compound returns over the holding period.
- **Liquidity**: Public investments are mostly liquid, whereas private investments are illiquid, with sale restrictions.
- **Investment process**: Public investments involve open-end security selection, while private investments involve a closed-end process with due diligence, value creation, and exit.

Asset Prices and Performance Measurement

In public markets, immediate access to current and historical price data for individual securities and relevant benchmarks supports various investment approaches, including judgment-based, rule-based, and index-based strategies. Investors can easily measure returns, volatility, and correlations across time to construct portfolios with an efficient risk/return tradeoff. Public market data are critical inputs for investment strategies.

Private market investors, lacking price transparency, rely on relative valuation techniques, discounted cash flow methods, and recent transactions to estimate prices. Fund managers provide valuation estimates to investors with delays and less frequent updates, limiting the usefulness of such data for asset allocation purposes. Performance measures for private investments must account for unpredictable cash flows, with multiple cash outflows and uncertain timing of inflows.

Liquidity and Investment Process

Active trading of listed securities in public markets offers a high degree of liquidity and relatively low transaction costs. The purchase and sale of listed securities can be as simple as executing a market order. Public market investors can respond to short-term market developments, buying undervalued securities or selling overvalued ones based on observed prices. Public equity and debt issuers are usually in a mature phase of development with predictable, stable cash flows.

Privately held controlling or minority stakes in a firm, project, or real asset are inherently illiquid. Fund managers typically require a larger capital commitment from investors and a longer investment time horizon, sometimes up to 10 years or more. Private purchases and sales are often negotiated between few potential buyers and sellers. Consequently, private fund managers often prohibit or severely restrict investors from selling fund positions to avoid early liquidation.

The features of public and private investments also give rise to distinct investment processes. The greater liquidity and price transparency of public investments allow for an open-end investment approach and structure. In contrast, investments in illiquid private assets benefit from a closed-end approach, aligning manager compensation with investment performance over a longer period. The private asset investment life cycle involves capital commitment, deployment, distribution, and exit phases, characterized by negative returns in early phases and increasing cash flows and income in later phases, known as the J-curve effect.

Manager Skills

Distinct investment processes and responsibilities among public and private fund managers require different skill sets. Public fund managers focus on industry, company, and financial analysis, delegating the value creation process to company managers. They use publicly available financial statements and data sources to create and compare financial ratios and metrics as a basis for investment analysis.

Private market investments often lack the market price transparency of public securities and include opportunities ranging from new real estate developments, to mature firms in financial distress, to startup companies with little more than a business idea. Managing these investments requires skills beyond security analysis. For real estate, local market knowledge and project development and management experience are critical. Private equity fund managers often bring significant operational experience and industry expertise, including relationships and management experience in founding, growing, or restructuring businesses. Legal, accounting, tax, and other qualifications are also crucial. Given the prevalence of less standardized contracts in private markets, both investors and managers must be prepared to conduct additional legal analysis.

Early-stage companies with little or no revenue often solicit private equity investments known as venture capital, involving high risk and a high rate of failure. A company's initial success is usually measured by nonfinancial milestones, such as establishing a product, identifying market potential, and developing a go-to-market strategy, before generating revenue or profits. Therefore, startup investors often bring relevant experience, contacts, and partnerships to help establish a successful business.

Portfolio Diversification Potential

The distinct features of private markets and investments commonly result in relatively low correlations between private market returns and those of public market securities. While a public market security's correlation relative to an existing public market portfolio may be easily estimated due to observed market prices, private markets' illiquidity and longer investment periods preclude such a comparison. The diversification potential of private market investments is assessed differently.

Key sources of potential diversification in private markets include:

- **Private company debt and equity exposures**: Private markets allow investments in life-cycle phases unavailable to public market investors, such as rapid growth or restructuring opportunities.
- **Private company return dynamics**: Private investments offer return dynamics that vary from those of mature public companies over an investment life cycle.
- **Alternative asset classes**: Exposures other than private company debt or equity, such as private real estate or infrastructure, exhibit different return dynamics from public securities.

Successful firms emerge from a startup period via rapid expansion, with cash flows and profitability rising until they reach a mature, stable phase and subsequently face decline. Public markets and investments are concentrated among mature companies, while private investments span the entire company life cycle, providing unique diversification opportunities.

Private vs. Public Investment Structures

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

Private investment structures differ significantly from public ones due to their complexity and the active role of managers throughout the investment life cycle. Public market investors typically choose between direct selection of individual securities and an indirect approach, where selection is delegated to a public fund manager. In contrast, private market investments often use closed-end fund structures based on limited partnerships. These structures align the interests of fund managers (general partners, or GPs) and investors (limited partners, or LPs) through shared risk and return.

Private Investment Methods

Private market investment methods depend on the investor's commitment size and ability to actively manage the investment. There are three common methods:

- **Direct investment**: This method involves purchasing an equity stake or private debt without intermediaries. Direct investors often take a controlling stake and must negotiate purchase prices and execute business plans. This method is typically used by large asset owners who can manage portfolio concentration risks.
- **Co-investment**: This approach can be direct, involving the purchase of a stake alongside partners, or indirect, where a LP invests in a single GP-managed investment. Co-investment allows investors to reduce portfolio positions, benefit from partner expertise, and reduce fees.
- **Fund investment**: LPs invest in funds managed by GPs, who handle the investment process and operations. This method involves performance-based compensation to align interests and manage information asymmetry.

Direct Investment

Direct investment involves purchasing a significant ownership stake or private debt without using an intermediary. This method is often employed in buyout equity transactions, where the investor must establish and execute a successful business plan. Direct investment requires substantial resources and expertise, limiting its use to the largest asset owners.

Indirect Investment

Indirect investments include co-investment and fund-based alternatives. Limited partner co-investment allows LPs to take larger stakes in specific assets managed by GPs, offering deeper insights into the investment process. These limited partnerships involve long and illiquid holding periods and uncertain capital calls and distributions. Performance-based compensation is used to align interests and manage risks.

Private Investment Structures

Private investment structures are generally less standardized than public investments, allowing for greater flexibility and customization to suit the specific needs and goals of investors and the nature of the assets being acquired.

Governance and Negotiated Terms

Private investment structures often involve unique corporate governance arrangements. Unlike public companies, which adhere to a one vote per share and majority rule system, private entities can negotiate specific provisions tailored to investor needs. For instance, a significant minority investor may secure a board seat or require supermajority votes for major decisions, effectively giving them veto power over strategic decisions. This negotiated governance structure is a key feature that distinguishes private investments from their public counterparts.

Special Purpose Entities (SPEs)

A common structure used in private investments, especially in real estate and infrastructure, is the special purpose entity. SPEs are created to manage specific projects or assets, isolating the associated liabilities, cash flows, and income from the broader balance sheets of the investors. This segregation protects investors by limiting their exposure to the project's specific risks and obligations. For example, in real estate, a project company is established to purchase undeveloped land, funded through equity contributions and secured debt.

In infrastructure projects, SPEs are often used in concession agreements where public and private entities collaborate under a contractual arrangement. This structure helps manage the planning, construction, financing, and maintenance of infrastructure assets over a finite period, providing clear roles and responsibilities for each stakeholder involved.

Leveraged Buyouts (LBOs)

Leveraged buyouts are a prevalent structure in private equity, where a significant portion of the purchase price is financed through debt. In a LBO, a new acquisition company (AcquisitionCo) is formed to buy out a target company (TargetCo). The assets of TargetCo are used as collateral for the acquisition debt. This structure allows the private equity firm to control the target company while leveraging the debt to enhance potential returns on equity. Post acquisition, TargetCo's operations are restructured to improve performance and profitability before it is eventually sold or taken public again.

Debt Structures in Private Investments

Private debt structures can vary significantly from public market debt instruments. They often include leveraged loans, mezzanine debt, and unitranche financing.

- **Leveraged loans**: Senior secured loans with floating interest rates and restrictive covenants, often used in LBOs
- **Mezzanine debt**: Subordinated debt that sits between senior debt and equity in the capital structure, offering higher returns due to its junior status and additional risk
- **Unitranche debt**: A combination of senior and subordinated debt into a single loan, providing a simpler alternative with one blended interest rate and fewer administrative burdens

In summary, private investment structures provide more flexibility than public investments and are often customized to meet the unique needs of the borrower and the investors. They involve negotiated governance terms, specialized entities like SPEs, and tailored debt instruments, allowing for a high degree of control and offering the potential for enhanced returns. Understanding these structures is crucial for managing private market investments effectively.

Private vs. Public Investments and Return Metrics

LOS: 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.

The distinct features of public and private markets lead to differences in liquidity, price transparency, performance dynamics, and performance measurement approaches. Private market investments, including private equity, debt, real estate, and infrastructure, face unique challenges in valuation due to their illiquidity and lack of price transparency. These investments are best measured over a multi-year holding period using metrics such as the internal rate of return (IRR).

Public versus Private Market Performance

Public markets involve listed equity and debt securities from mature issuers with stable cash flows. These investments are characterized by liquidity, price transparency, and ease of performance measurement. Analysts use periodic measures such as dividends and bond coupons to calculate returns.

Private market investments, in contrast, lack such price transparency and involve more complex valuation methods. The IRR is commonly used for private market performance measurement, accounting for the time value of money and the irregular cash flows typical of these investments.

Example 1: IRR calculations

Public investment: An endowment fund manager invests USD 600,000 in a public company, expecting to treble the investment value over nine years (i.e., ROI = 3x). The IRR is calculated as follows:

$$3 = (1 + \text{IRR})^9$$

$$3^{1/9} - 1 = \text{IRR}, \text{IRR} = 12.98\% \text{ (rounded)}$$

Private investment: The same manager commits to invest USD 600,000 in a private equity fund in three years, expecting an ROI of 3x over the nine-year period beginning today. Accounting for the three-year delay, the IRR is calculated:

$$\text{FV} = 600{,}000 \times (1 + 12.98\%)^6 \approx 1{,}247{,}845$$

For the private investment, if the manager assumes that the investment will generate the same 12.98% IRR, the manager must also assume that the investment will generate no return on investment for the first three years, which explains why the FV is approximately 1.2 million rather than 1.8 million. The ROI for the six years of actual investment = 1,247,845 / 600,000, or almost 2.08. Using this ROI, the IRR is calculated as:

$$2.08 = (1 + \text{IRR})^9$$

$$(2.08)^{1/9} - 1 = \text{IRR}, \text{IRR} \approx 8.48\%$$

Cash Flows and J-Curve Effects in Private Market Portfolios

Private market investments typically exhibit J-curve effects, where early negative returns due to capital deployment and fees are followed by positive returns as the investments mature and generate cash flows.

Example 2: Willowbridge investment fund performance

Willowbridge Partners deployed capital among three assets over two years, each generating cash inflows and exit values after three years. The IRRs for the investments were as follows:

- Asset 1: Initial investment of USD 25 million, generating annual inflows of USD 6 million and a final inflow of USD 35 million with an IRR of 28.1%
- Asset 2: Initial investment of USD 35 million, generating annual inflows of USD 7 million and a final inflow of USD 40 million with an IRR of 18.4%
- Asset 3: Initial investment of USD 20 million, generating annual inflows of USD 4 million and a final inflow of USD 28 million with an IRR of 25.2%

What is the Willowbridge Investment Fund's IRR?

Solution

The cash flows for each asset are shown in the following table:

Cash flows in Year	0	1	2	3	4	5
Asset 1	−25	6	6	35		
Asset 2		−35	7	7	40	
Asset 3			−20	4	4	28
Net cash flows	−25	−29	−7	46	44	28

Inputting the cash flow totals into a financial calculator, the IRR for the fund is calculated as approximately 23.51%.

It would be incorrect to calculate the fund's IRR as the average of each of the asset's individual IRR. Although each asset has the same life (three years), the cash flows occur at different times, so an investor would have to net each year's cash flow and calculate the IRR based on the netted cash flows.

Public market equivalent (PME) methodologies are used to compare the returns of private market funds with those of public market indexes. This approach translates the uneven cash flows of private market investments into a comparable public market return. PME creates a theoretical public market investment where private fund cash outflows are invested in a public market index and cash inflows are sold from the public market index. A terminal value is calculated from this hypothetical cash flow stream at the end of the private fund's life, and the PME IRR is calculated based on the private fund's cash flows, with the PME's terminal value replacing the fund's exit value.

This approach provides a theoretically accurate method to account for the timing differences in cash flows when comparing private and public market returns, making PME a valuable tool for investors in assessing private market fund performance, as demonstrated in Example 3.

Example 3: Oxbridge public market equivalent

Oxbridge recently closed a USD private equity fund with a four-year life. Assume that each cash flow shown occurs at the beginning of the year. The fund's cash flows and a comparable public market index (with the return for each year in parentheses) are shown below:

- Year 0: Fund cash flow = USD −50 million, Public market index = 100
- Year 1: Fund cash flow = USD −20 million, Public market index = 120 (20%)
- Year 2: Fund cash flow = USD 0, Public market index = 110 (−8.3%)
- Year 3: Fund cash flow = USD 25 million, Public market index = 135 (22.7%)
- Year 4: Fund cash flow = USD 70 million, Public market index = 144 (7.4%)

The fund's IRR is 9.25%, and the public market index compound annual return is 9.73%. Did Oxbridge outperform its PME?

Solution

The concept is to compare Oxbridge's IRR with the IRR that would have resulted if the fund's cash flows had been invested at the market rate of return each year.

1. **Benchmarking fund performance:** Oxbridge should not benchmark its fund's IRR against the public market index's compound annual return, as the public market return calculation ignores the timing of the fund's cash flows.
2. **Calculating PME asset values:**
   - Year 0: Invest USD 50 million in the public market index.
   - Year 1: Add USD 20 million to the PME asset value and account for the public market return (PME asset value = USD 50 million × 1.20 + USD 20 million = USD 80 million).
   - Year 2: Adjust for the public market return (PME asset value = USD 80 million × 0.9167 = USD 73.33 million).
   - Year 3: Account for the public market return (PME asset value = USD 73.33 million × 1.1818 = 86.67) and then subtract USD 30 million, which represents the distribution to the investors, for a Year 3 ending PME value of USD 56.67 million.
   - Year 4: Adjust for the public market return (PME asset value = USD 56.67 million × 1.0769 = USD 61.02 million).
3. **Evaluating fund performance:** The PME IRR, based on Oxbridge's cash flows and the PME terminal value of USD 69.81 million, is calculated as approximately 7.4%. Since Oxbridge's fund IRR of 9.25% exceeds the PME IRR of 7.4% (instead of the PME compound return of 9.7%), Oxbridge has outperformed the public market benchmark.

Private Market Fund Multiples

GPs use various return multiples to communicate performance to LPs, providing more detail than the simple return on investment measure over the entire investment life cycle. These multiples include:

- **Paid-in capital (PIC)**: Measures the proportion of total capital committed that has been deployed

$$\text{PIC} = \frac{\text{Capital invested}}{\text{Total capital committed}}$$

- **Distributed to paid-in (DPI)**: The ratio of cumulative distributions to LPs to the capital invested, indicating realized returns

$$\text{DPI} = \frac{\text{Cumulative distributions}}{\text{Total capital invested}}$$

- **Residual value to paid-in (RVPI)**: Measures the fund's net asset value (NAV) as a proportion of the total invested capital, reflecting unrealized returns

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

- **Total value to paid-in (TVPI)**: Combines both realized and unrealized gains

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

Effects of Private Market Features on Risk and Return

Private market investments often have longer holding periods and are associated with J-curve effects. These investments are more reliant on price appreciation over the investment life cycle, as opposed to the stable cash flows typical of public market investments.

Asset Allocation with Private Markets

Investors must plan and stage their private investments carefully, considering the need for liquidity planning, pacing strategies, and maintaining relationships with GPs. This involves committing a proportion of assets to an asset class or strategy each period and factoring in the uncertain distribution size and timing.

Effects of Private Market Features on Risk and Return

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

Private market investments have unique characteristics that impact both risk and return profiles compared with public market investments. These characteristics lead to significant differences in how returns are generated and how risks are managed.

- **Illiquidity**: Private market investments are generally illiquid, meaning they cannot easily be sold or exchanged for cash without a substantial loss in value. This illiquidity premium can contribute to higher expected returns.
- **Valuation uncertainty**: Valuations in private markets are less transparent and more challenging to determine than in public markets. This uncertainty can lead to higher risk, but also opportunities for significant upside if the asset is undervalued.
- **Long investment horizons**: Investments in private markets typically have longer holding periods. This long-term focus allows for the realization of value creation strategies that might not be feasible in the short term.
- **Active management**: Private investments often involve a more active management role, including operational improvements, strategic direction, and restructuring efforts, which can enhance returns.
- **Concentration risk**: Private market portfolios often have higher concentration risks due to larger position sizes in individual investments, compared with diversified public market portfolios.

Risk and Return Across Asset Classes

Different private market asset classes offer varied risk and return profiles, reflecting their unique characteristics and the nature of their underlying investments.

- **Private equity**: Includes venture capital, growth equity, and buyout investments. Private equity typically involves high risk, due to the early-stage nature of many investments, but also offers the potential for high returns, especially in successful buyouts or IPOs.
- **Private debt**: Encompasses venture debt, mezzanine debt, and direct lending. Private debt investments generally provide more stable returns compared with equity but come with credit risk and potential illiquidity.
- **Real estate**: Private real estate investments can vary from core, stabilized properties with predictable cash flows to opportunistic projects with significant development or repositioning risks. Real estate offers the potential for capital appreciation and income generation through rents.
- **Infrastructure**: Investments in infrastructure assets such as utilities, transportation, and renewable energy projects. Infrastructure investments often provide stable, long-term cash flows with inflation protection but can be subject to regulatory and political risks.
- **Special situations**: Distressed assets, turnaround opportunities, and other unique investment situations. These investments can offer high returns due to the significant value creation potential but are often accompanied by high risk and complexity.

Asset Allocation with Private Markets

Integrating private markets into an overall asset allocation strategy involves several considerations to balance the benefits of diversification and potential for higher returns against the challenges of liquidity and risk management.

- **Strategic allocation**: Determining the appropriate allocation to private markets within a broader portfolio strategy, considering the investor's risk tolerance, investment horizon, and return objectives
- **Liquidity planning**: Ensuring sufficient liquidity to meet ongoing capital calls and potential unforeseen cash needs, while maintaining the ability to invest in attractive opportunities as they arise
- **Pacing strategy**: Implementing a disciplined approach to gradually build exposure to private markets over time, managing the timing of capital commitments and deployments to avoid concentration in specific vintages or market cycles
- **Manager selection**: Identifying and partnering with skilled managers who have a proven track record and expertise in specific asset classes or investment strategies, as the quality of the manager can significantly impact investment outcomes
- **Diversification**: Achieving diversification within private markets by investing across different asset classes, geographies, and sectors to reduce idiosyncratic risks associated with individual investments or market segments
- **Performance monitoring**: Regularly assessing the performance of private market investments relative to benchmarks and objectives, adjusting the strategy as needed based on market conditions and investment performance

Private Markets Pathway
Learning Module 2
General Partner and Investor Perspectives and the Investment Process

LOS: Discuss a general partner's roles and responsibilities in managing private investment funds.

LOS: 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.

LOS: Discuss favorable characteristics of private investment targets and sources of value creation in private markets.

LOS: Discuss the role of conducting due diligence and establishing a business plan in the private investment process.

LOS: Discuss alternative exit routes in private investments and their impact on value.

General Partner Roles and Responsibilities

LOS: Discuss a general partner's roles and responsibilities in managing private investment funds.

In private market investments, the general partner (GP) plays a critical role in managing the investment process and ensuring that the fund's objectives are met. The GP is responsible for a wide range of activities, from sourcing investment opportunities to managing exits. These responsibilities span several key phases of the investment life cycle.

Pre-Commitment

Before any capital is committed, the GP undertakes a variety of preparatory activities:

- **Defining the investment strategy:** The GP develops a clear investment thesis, identifying target sectors, geographies, and types of investments that align with the fund's objectives.
- **Setting up the legal and organizational structure:** This includes forming the fund entity, drafting offering documents, and setting up governance frameworks.
- **Marketing the fund:** The GP presents the fund to potential investors (limited partners, or LPs), highlighting the strategy, past performance, and potential benefits of investing in the fund.
- **Due diligence on potential investments:** Preliminary assessments and market research are conducted to identify promising opportunities that fit the investment strategy.

Capital Commitment

Once the fund is established, the GP focuses on securing commitments from LPs. This phase involves:

- **Formalizing commitments:** Legal agreements are executed, specifying the terms of investment, capital commitment amounts, and timelines.
- **Establishing capital call mechanisms:** Procedures are put in place for drawing down committed capital from LPs as investment opportunities arise. These procedures include detailed schedules and conditions under which capital will be called.
- **Communication and coordination:** Effective communication is maintained with LPs to manage expectations and ensure readiness for capital calls. Regular updates on market conditions and potential investment opportunities are provided to keep LPs informed.

Capital Deployment

In the capital deployment phase, the GP actively seeks and executes investment opportunities. Key activities include:

- **Sourcing deals:** The GP leverages its network, industry knowledge, and market research to identify attractive investment opportunities.
- **Conducting due diligence:** A thorough assessment of potential investments is carried out, including financial analysis, market analysis, legal due diligence, and operational assessments.
- **Negotiating terms:** The GP negotiates the terms of the investment, including valuation, ownership structure, and rights and protections for the fund.
- **Structuring deals:** Investments are structured to align with the fund's strategy and objectives, often involving complex financial arrangements.
- **Executing transactions:** The GP oversees the transaction process, ensuring that all legal and financial requirements are met and that the investment is successfully closed.

Capital Distribution and Exit

The final phase of the investment life cycle involves managing investments to generate returns and eventually exiting these investments. This phase includes:

- **Enhancing value:** The GP works closely with portfolio companies to implement strategic, operational, and financial improvements. This might involve restructuring, cost optimization, market expansion, or other value-enhancing activities.
- **Monitoring and governance:** Regular performance monitoring and active involvement in governance help ensure that the portfolio companies are on track to meet their objectives.
- **Planning exits:** The GP develops exit strategies tailored to each investment, considering market conditions and potential buyers.
- **Executing exits:** Exits can be achieved through various means, such as initial public offerings (IPOs), sales to strategic buyers, or secondary transactions. The timing and method of exit are chosen to maximize value.
- **Distributing proceeds:** The GP manages the distribution of proceeds to LPs according to the terms of the fund agreement, ensuring transparency and compliance with all legal and financial obligations.

Investor Perspectives, Fees, and Performance Measurement

LOS: 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.

Management Fees

Management fees are annual fees paid by LPs to the GP for managing the fund. These fees cover the GP's operational expenses, including salaries, office rent, and administrative costs.

Management fees are typically calculated as a percentage of the committed capital during the investment period and of the invested capital thereafter. Delays in drawing down the committed capital do not change management fees.

Management fees are adjusted by investments that the fund writes off as well as distributions made to LPs.

Example 1: Oakwood Capital Partners management fees

Oakwood Capital Partners is a private equity firm that has recently closed a new fund with total committed capital of USD 750 million. The fund has a typical structure with a 2% management fee during the investment period, which lasts for three years, and a 1.5% management fee on invested capital thereafter. The investment period begins in Year 0 and ends in Year 3.

Year-by-year breakdown

- **Year 0:** The fund is launched, and Oakwood starts collecting management fees based on the total committed capital.

  $$\text{Management fee} = 2\% \times 750 \text{ million} = 15 \text{ million}$$

- **Year 1:** The fund deploys USD 150 million of the committed capital.

  $$\text{Management fee} = 2\% \times 750 \text{ million} = 15 \text{ million}$$

- **Year 2:** The fund deploys an additional USD 200 million, making the total invested capital USD 350 million.

  $$\text{Management fee} = 2\% \times 750 \text{ million} = 15 \text{ million}$$

- **Year 3:** The fund deploys another USD 400 million, bringing the total invested capital to USD 750 million.

  $$\text{Management fee} = 2\% \times 750 \text{ million} = 15 \text{ million}$$

Post-investment period

After Year 3, the management fee structure changes to 1.5% of the invested capital.

- **Year 4:** The fund has fully invested the USD 750 million. The management fee is now based on the invested capital.

  $$\text{Management fee} = 1.5\% \times 750 \text{ million} = 11.25 \text{ million}$$

- **Year 5:** The fund starts to exit some investments, returning USD 100 million to the LPs. The invested capital is now USD 650 million.

  Management fee = 1.5% × 650 million = 9.75 million

- **Year 6:** The fund writes off USD 15 million in investments and returns an additional USD 135 million to the LPs, reducing the invested capital to USD 500 million.

  Management fee = 1.5% × 500 million = 7.5 million

Summary of management fees over time

- Years 0–3: Annual management fee of USD 15,000,000 based on committed capital.
- Year 4: Annual management fee of USD 11,250,000 based on invested capital.
- Year 5 Annual management fee of USD 9,750,000 after USD 100 million is returned.
- Year 6: Annual management fee of USD 7,500,000 after accounting for the USD 15 million write-off and the return of USD 135,000,000 to investors.

Carried Interest

Carried interest, also known as “carry,” is a performance-based fee paid to the GP. It is typically around 20% of the profits generated by the fund after returning the initial capital and preferred returns to the LPs. Carried interest aligns the interests of the GP with those of the LPs by incentivizing the GP to maximize the fund’s performance.

Hurdle Rates

Hurdle rates, also known as preferred returns, are the minimum rate of return that must be achieved before the GP can earn carried interest. The hurdle rate ensures that LPs receive a minimum return on their investment before the GP is compensated for performance. Typical hurdle rates are around 8%.

There are two types of hurdle rates:

- A hard hurdle rate means that the GP earns carried interest only on the profits that exceed the hurdle rate. This type of hurdle rate is more favorable to LPs and provides them with greater protection, as it ensures that the preferred return is achieved before any performance fee is distributed to the GP. This can lead to more conservative and diligent investment strategies by the GP to ensure that the preferred return is surpassed.

Example 2: Hard hurdle rate

A private equity fund has committed capital of USD 200 million and a hard hurdle rate of 8%. Over the investment period, the fund generates total profits of USD 50 million.

- Calculate the hurdle amount: 200,000,000 × 0.08 = USD 16,000,000
- Determine profits exceeding the hurdle rate: 50,000,000 − 16,000,000 = USD 34,000,000
- Carried interest (20% carry): 0.20 × 34,000,000 = USD 6,800,000

The GP earns carried interest only on the USD 34 million that exceeds the hurdle rate.

- A soft hurdle rate allows the GP to earn carried interest on the entire profit once the hurdle rate is met. This structure is less favorable to LPs but can still align interests if structured properly.
  - A soft hurdle rate can incentivize GPs to take on higher risk for potentially higher returns, knowing that any return above the hurdle rate will generate carried interest.

Example 3: Soft hurdle rate

Using the same numbers as the fund in Example 2, calculate the soft hurdle amount.

Solution

- Calculate the hurdle amount: 200,000,000 × 0.08 = USD 16,000,000
- Determine profits: USD 50,000,000
- Carried interest (20% carry): 0.20 × 50,000,000 = USD 10,000,000

In this case, the GP earns carried interest on the entire USD 50 million once the hurdle rate is achieved.

Catch-Up Clause

A catch-up clause in private equity funds is a provision that allows the GP to receive a larger portion of the profits after the LPs have received their preferred return or hurdle rate. This clause is designed to ensure that the GP is adequately incentivized to maximize the overall returns of the fund by aligning their interests with those of the LPs. The catch-up clause specifies how much of the profits above the hurdle rate will be allocated to the GP until a predetermined split of profits between the GP and LPs is achieved.

How the Catch-Up Clause Works

Once the hurdle rate is met, the catch-up clause kicks in, allowing the GP to “catch up” on the carried interest. This is typically structured so that the GP receives 100% of the profits until the carried interest percentage is aligned with the agreed-upon profit split (usually 80/20 in favor of LPs).

Example 4: Catch-up clause

A private equity fund has the following characteristics:

- Committed capital: USD 300 million
- Hurdle rate: 8%
- Carried interest: 20%
- Catch-up provision: 100% catch-up
- Assume that the fund generates total profits of USD 60 million

Calculate the distributions to the GP and LPs.

Solution

- Hurdle amount: 300,000,000 × 0.08 = USD 24,000,000. The LPs must receive USD 24 million before the GP can earn any carried interest.
- Distribute the hurdle rate: The first USD 24 million of profits go entirely to the LPs to satisfy the hurdle rate.

- Calculate remaining profits: 60,000,000 − 24,000,000 = USD 36,000,000
- Catch-up allocation: According to the catch-up clause, the GP will receive 100% of the profits after the hurdle rate until the 20% carried interest is reached on the total profits (USD 60 million): GP's catch-up amount = 0.20 × 60,000,000 = USD 12,000,000
- Distribute remaining profits: After the GP has caught up, the remaining profits are split according to the agreed profit split (80% to LPs, 20% to GP).
  - Profits before catch-up: 24 million (hurdle) + 12 million (GP catch-up) = USD 36 million
  - Remaining profits to be split: 60 million − 36 million = USD 24 million
- Final distribution:
  - LPs: Hurdle rate (24 million) + 80% of remaining profits (80% of 24 million) = 24 million + 19.2 million = USD 43.2 million
  - GP: Catch-up (12 million) + 20% of remaining profits (20% of 24 million) = 12 million + 4.8 million = USD 16.8 million
- **Summary of distribution:**
  - **Total profits:** USD 60 million
  - **LPs' total share:** USD 43.2 million
  - **GP's total share:** USD 16.8 million

Importance of the Catch-Up Clause

The catch-up clause is critical for aligning the incentives of the GP with those of the LPs. It ensures that the GP is motivated to exceed the hurdle rate and achieve high returns, benefiting both parties. By allowing the GP to catch up on carried interest, the clause encourages the GP to work diligently toward maximizing the fund's performance.

Key points about the catch-up clause

- **Incentive alignment:** Ensures GPs are motivated to exceed the hurdle rate and deliver strong performance.
- **Profit distribution:** Specifies how profits are allocated after the hurdle rate is achieved, with a temporary allocation favoring the GP until the carried interest is aligned with a predetermined split.
- **Fairness:** Balances the interests of both LPs and GP, providing fair compensation for the GP's efforts once the LPs' preferred returns are met.

Clawbacks

Clawbacks are provisions that require the GP to return any excess carried interest to the LPs if the fund's performance declines in later stages. This ensures that the GP does not receive more than its fair share of profits over the life of the fund. Clawbacks protect LPs from overpayment in situations where early distributions are high but later investments underperform.

Example 5: Clawbacks

A GP receives USD 40 million in carried interest based on early profits. However, subsequent investments result in losses, reducing the overall performance of the fund. If the final profits justify only USD 30 million in carried interest, the GP must return the excess amount to the LPs.

Clawback amount = 40,000,000 − 30,000,000 = USD 10,000,000

High-Water Marks

A high-water mark is a fund's highest historical value. High-water marks ensure that GPs are rewarded only for performance that exceeds the highest level previously achieved by the fund. This mechanism prevents GPs from earning carried interest on the recovery of losses.

Example 6: High-water mark

A fund pays carried interest to its GP at the rate of 20%. This fund also has a high-water mark of USD 100 million. If it experiences a decline to USD 80 million, the fund must surpass the previous high-water mark of USD 100 million before the GP can earn carried interest on new profits. If the fund grows to USD 110 million, the GP earns carried interest only on the USD 10 million above the high-water mark.

Private Investment Selection and Value Creation

LOS: Discuss favorable characteristics of private investment targets and sources of value creation in private markets.

Private investment selection and value creation are crucial aspects of the private equity investment process. These steps involve meticulous due diligence, strategic planning, and active management to enhance the value of portfolio companies.

Investment Selection Process

The investment selection process is fundamental to private equity investing. It involves identifying potential investment opportunities, conducting thorough due diligence, and making informed investment decisions.

- **Deal sourcing:** This involves identifying potential investment opportunities through various channels such as industry networks, investment banks, and other intermediaries. GPs leverage their industry expertise and relationships to source deals that align with their investment strategy.
- **Screening:** After sourcing, potential investments are screened to ensure they meet the fund's criteria. This preliminary analysis includes assessing the company's financial health, market position, and growth potential.
- **Due diligence:** Detailed due diligence is conducted to evaluate the investment's potential risks and returns. This process includes financial analysis, market analysis, legal review, and operational assessments. Due diligence helps in understanding the company's strengths, weaknesses, opportunities, and threats (SWOT analysis).

Value Creation Strategies

Once an investment is made, the focus shifts to creating value within the portfolio company. GPs employ various strategies to enhance the company's performance and increase its value over the investment period.

- **Operational improvements:** Implementing changes to improve operational efficiency, reduce costs, and increase profitability. This could involve restructuring the organization, optimizing supply chains, or enhancing production processes.

- **Strategic initiatives:** Developing and executing strategic initiatives such as market expansion, product development, and entering new markets. These initiatives aim to drive growth and increase the company's market share.
- **Financial engineering:** Using financial leverage and restructuring to optimize the company's capital structure. This may include refinancing debt, managing working capital more effectively, and optimizing the balance sheet.

Due Diligence and Strategy Execution

LOS: Discuss the role of conducting due diligence and establishing a business plan in the private investment process.

Conducting due diligence and establishing a business plan are critical components in the private investment process. GPs investing in illiquid, long-term assets such as private equity, private debt, real estate, or infrastructure undertake extensive due diligence. This process extends beyond identifying intrinsic versus fair market value or growth opportunities; it also involves crafting a comprehensive business and financing plan to achieve targeted returns over the investment life cycle.

Company Due Diligence and Business Plans

Company due diligence encompasses a wide array of factors that can influence company performance, ranging from macroeconomic trends to company-specific elements like market share. Due diligence for private equity GPs, however, is more exploratory and varies significantly depending on the life-cycle stage of the company in question.

For early-stage companies, the due diligence process focuses heavily on technical aspects and the founders' ability to scale the product. GPs seek to understand the viability and scalability of the company's technology, market potential, and regulatory pathways.

For more mature companies, the process involves a thorough review of nonpublic information.

- After signing a nondisclosure agreement, GPs gain access to detailed data rooms containing legal and organizational information, commercial data, financial statements, human resources details, intellectual property information, IT infrastructure, compliance and litigation records, ESG issues, and taxation details.
- The rise of virtual data rooms has significantly enhanced the efficiency and security of the due diligence process.

Project Due Diligence

Project due diligence differentiates between the construction/development phase and the operational phase. Initially, the focus is on the location, physical attributes, and stakeholders involved in construction. This phase ensures that all regulatory requirements and construction standards are met and that the project is feasible from both technical and economic perspectives.

Once the project is complete, due diligence shifts to ensuring that the expected payments from the project will compensate for the associated risks. This involves a thorough analysis of market conditions, regulatory factors, and contractual commitments. The project business plans developed during this phase are milestone-driven and aim to transition the project to an income-producing phase as efficiently as possible.