

LM01 Private Investments and Structures

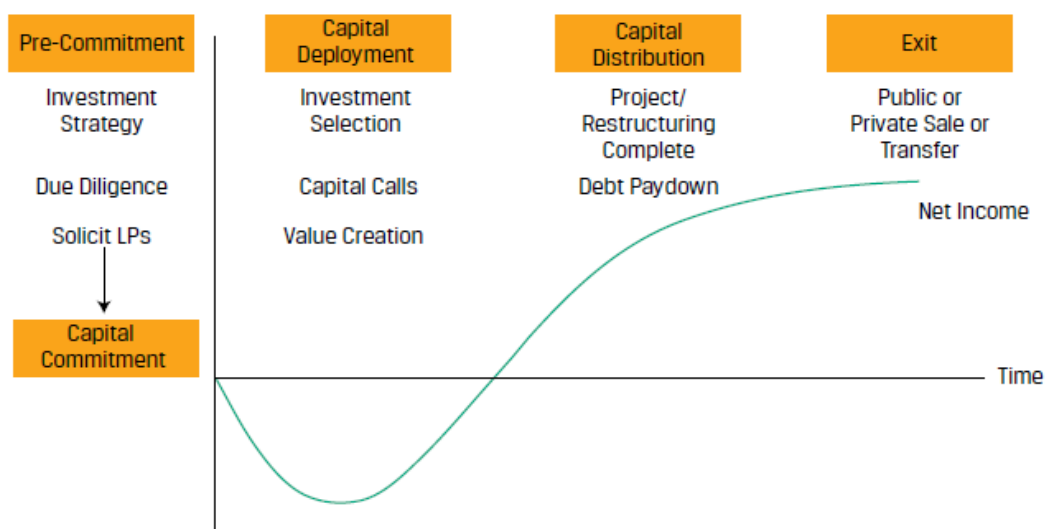
Features of private and public investments and markets

Exhibit 1 from the curriculum compares the features of public vs private investments.

Feature	Public	Private
Asset prices	Traded, observable	Negotiated, estimated
Performance measurement	Periodic	Compounded over holding period
Liquidity	Mostly liquid, with few trading restrictions	Illiquid, with sale prohibited or restricted
Investment process	Open-end, security selection	Closed-end, with due diligence, value creation, and exit
Investment manager skills	Industry, company, and financial analysis	Industry, management, and technical experience and expertise, legal and financial analysis
Portfolio diversification potential	Based on correlations of observed periodic returns	Based on different company and investment life cycle phases, as well as unique asset types

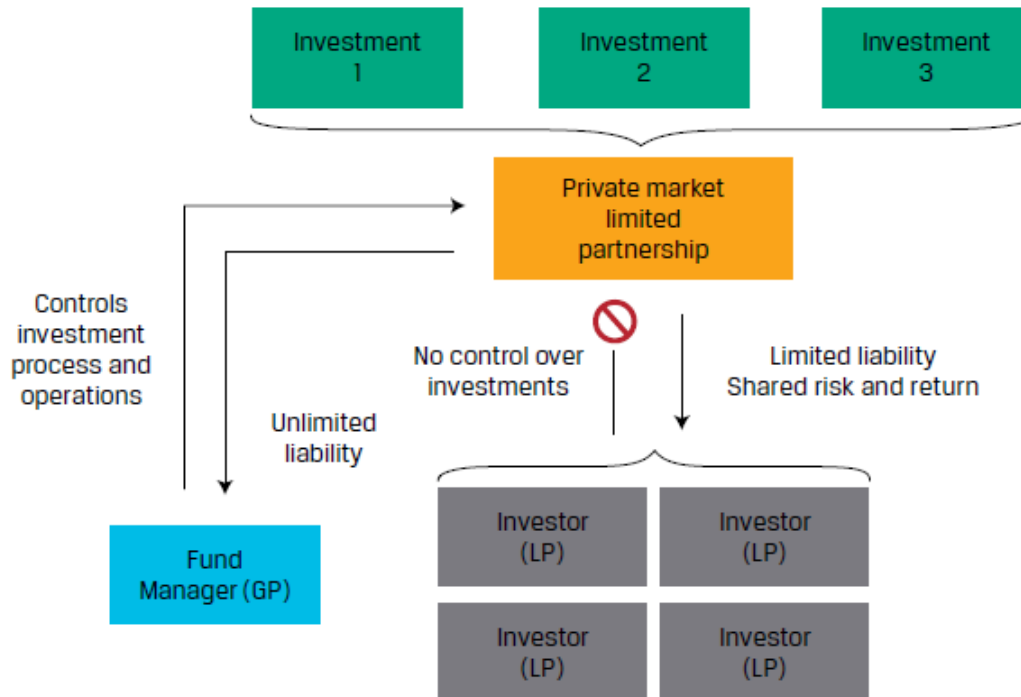
Liquidity and Investment Process

Private assets are inherently illiquid. Fund managers usually seek a larger commitment from investors and require a far longer investment time horizon than for public funds, sometimes up to 10 years or more. The development or transformation of private assets over this longer investment holding period is referred to as the private asset investment life cycle, whose distinct phases are shown in the below Exhibit from the curriculum:



Private investment methods and structures and their uses

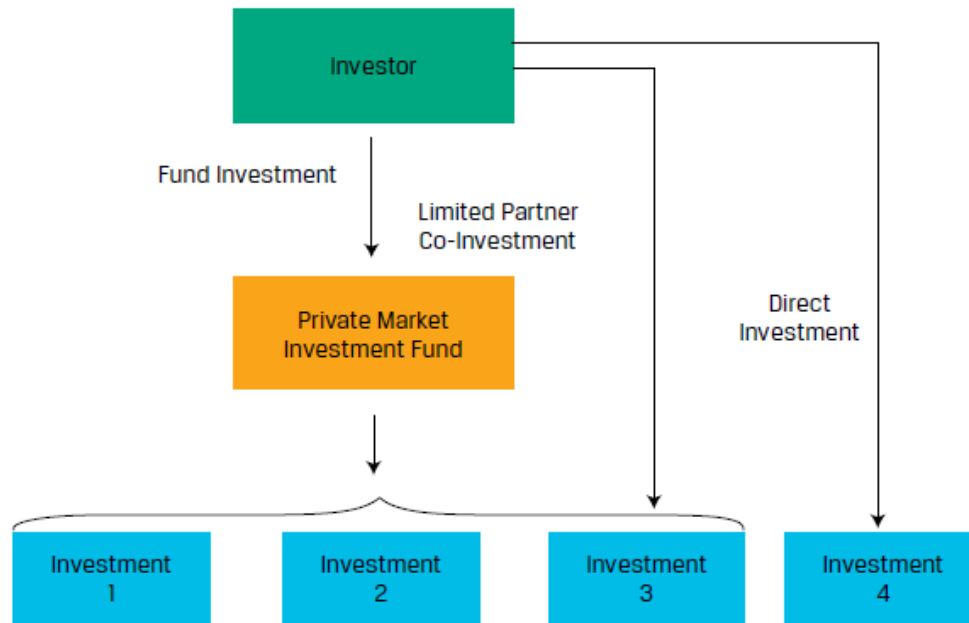
Private market investments often use a closed-end, limited partnership structure, as shown in Exhibit 4.



The fund manager assumes the role of a general partner (GP). He has control over the investment process and operations and has unlimited liability. The investors assume the role of limited partners (LPs). They have limited liability (they are liable only to the extent of the amount invested), but for this limited liability, they have to give up control over investments.

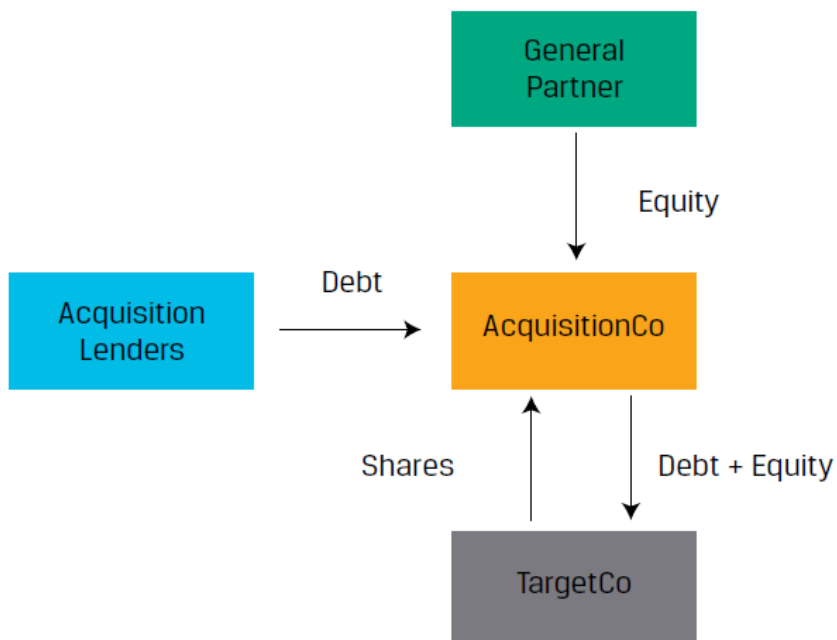
Private Investment Methods

In private markets, investors choose between Direct Investment, Co-Investment, and Fund Investment Alternatives based on their resources and willingness to manage the investment, as outlined in the following Exhibit from the curriculum.



Private Investment Structures

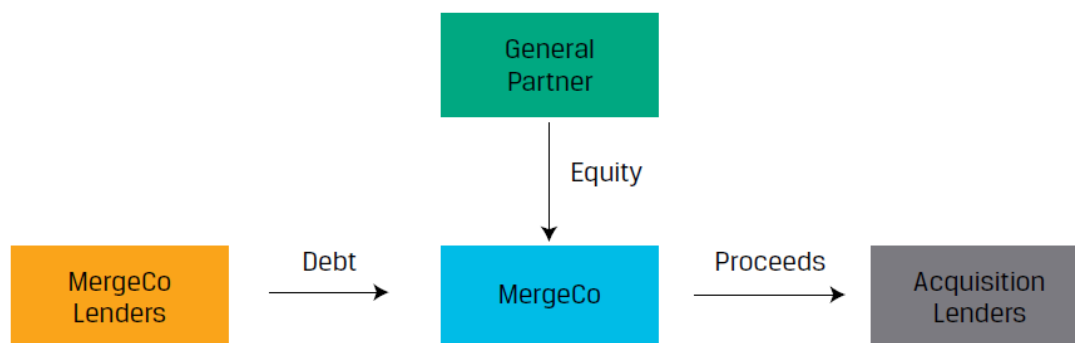
In a leveraged buyout (LBO), a new entity, Acquisition Co, is created to facilitate the acquisition of TargetCo, using a high level of debt financing alongside equity from the buyout firm. This is illustrated in Exhibit 6 below:



In the second stage of the buyout, long-term financing is negotiated after the deal is closed. In some cases, an acquiror may have arranged to simultaneously sell certain divisions of

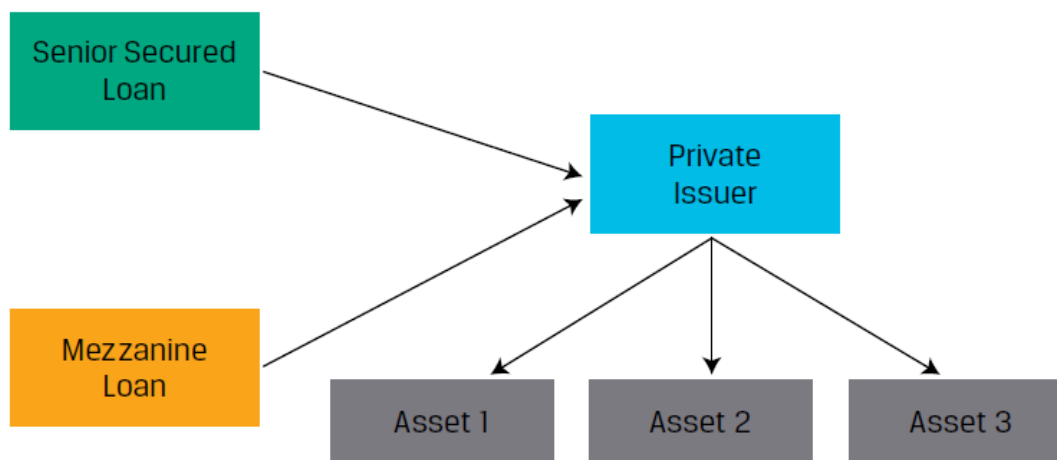
TargetCo or combine the target with another company it already owns. In other cases, such actions may take place in a later restructuring phase.

At this time, AcquisitionCo and TargetCo are combined in a merger (MergeCo), and the acquisition financing is replaced with medium- and long-term debt issued by the new legal entity, as shown in the following Exhibit from the curriculum:

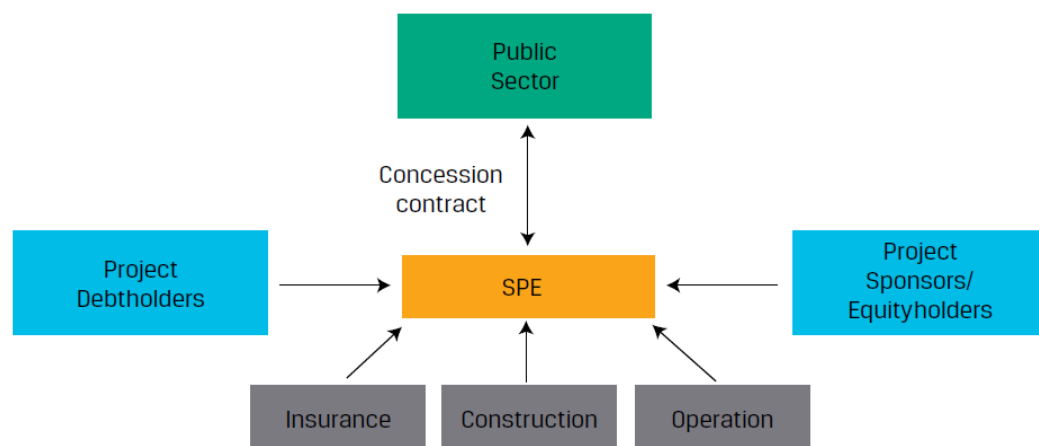


Private market debt strategies, such as those in leveraged buyouts, feature flexible structures to accommodate issuer and lender needs, unlike the fixed-coupon bonds in public markets.

Private debt investors can either directly engage with borrowers or invest via private credit funds to access senior secured debt or mezzanine loans.



Project based private investments in the areas of real estate or infrastructure also often involve the establishment of a special purpose entity (SPE). The entity's sole purpose is to facilitate the construction, operation, and financing of a real estate or infrastructure asset. This is illustrated in Exhibit 9 of the curriculum.



Private vs public investments and return metrics

Public markets are transparent and liquid, aiding analysis. Private markets lack these features, making valuation harder.

Long-term performance in private markets is best measured by internal rate of return (IRR), though IRR assumes reinvestment at the same rate, which might not apply in illiquid markets.

Return on Investment (ROI) is a simpler metric comparing cash received to invested.

$$ROI = \frac{\sum(\text{Cash flows received})}{\sum(\text{Cash flows invested})}$$

ROI doesn't account for time value of money.

For single-outlay investments, ROI can be converted to an equivalent IRR over the holding period, illustrating their relationship.

$$ROI = (1 + IRR)^n$$

Public Market Equivalent (PME) methodologies compare private market fund returns with public markets by simulating private cash flows in a public index, adjusting for timing discrepancies. This creates a terminal value for calculating the PME IRR, offering a direct comparison to public market performance.

GPs use return multiples to convey investment performance to LPs, offering insights into realized vs. unrealized returns.

These multiples include Paid-In Capital (PIC), Distributed to Paid-In (DPI), Residual Value to Paid-In (RVPI) and Total Value to Paid-In (TVPI),

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

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

$$\text{RVPI} = \frac{\text{Net asset value}}{\text{Total capital invested}}$$

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

Private vs public risk and return

After the Global Financial Crisis, private markets, particularly private equity, outperformed public markets, with an average IRR of 20.1% compared to the S&P 500's 11.8%.

Private equity displays significant return variability, emphasizing the importance of manager skill, while other private assets show less variability among managers.

Investors looking into private markets must account for longer holding periods and the J-curve effect, which distinguish them from public markets and affect risk and returns.

LPs in private markets need to plan for liquidity carefully, adopt a consistent investment pacing strategy, and maintain strong GP relationships to optimize returns, considering the complexities and illiquidity of these investments.

Private equity targets companies at various growth stages for higher returns, focusing on innovation and leveraging buyouts. While offering diversification and potential outperformance, these investments are tied to public market dynamics through valuation and pricing.

Public fixed-income involves low-risk, stable bonds, while private debt covers riskier options like venture debt and mezzanine debt, offering varied risk-return profiles due to higher default risks and illiquidity.

Public real estate investments like REITs offer stable cash flows from direct property ownership. In contrast, private real estate focuses on higher-risk development projects, expecting greater returns for their longer duration, market risks, and illiquidity compared to more diversified public REITs.

Public infrastructure involves mature companies with consistent cash flows, while private infrastructure focuses on riskier new projects expecting higher returns and diversification. Special situations investments in private markets aim for high returns from distressed or event-driven opportunities, thriving during economic downturns.