

LM01 Private Investments and Structures

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1. Introduction

Over the past few decades, institutional investors have significantly increased their private market asset allocations to diversify their portfolios and complement their traditional public market investments.

According to Preqin, an alternative data provider, the private market assets under management (AUM) rose from under \$1 trillion in 2000 to nearly \$12 trillion in 2022.

Originally dominated by major players such as sovereign wealth funds and endowments, private market investments now extend to smaller institutional investors and high-net-worth individuals.

Therefore, given the increased interest in private markets, CFA Institute has introduced the Level III Private Markets Pathway to equip finance professionals with the necessary skills to identify, target, evaluate, and manage these investments.

While public markets often feature more standardized, liquid securities of mature issuers with price transparency, private investments are characterized by unique, illiquid investments across a broader range of company life cycle stages or project development phases and are typically held for longer periods.

This unique nature, coupled with different investment methods and structures, positions private market investments as complementary to traditional public equity and fixed-income securities in strategic asset allocation strategies.

2. Features of Private and Public Investments and Markets

Public investments involve securities like debt or equity that are traded on exchanges or over-the-counter markets. Public fund managers invest in established issuers, typically with stable cash flows. These investments offer liquidity and readily observable prices.

Private investments are unlisted assets and involve companies that choose not to or cannot access public markets due to their size, stage of development, or limited financial disclosure. Private debt and equity contracts are negotiated rather than exchanged on a regular basis.

It is also important to distinguish between alternative investments and private investments, terms that are often used interchangeably. Traditional investments refer to long-only positions in stocks, bonds, and cash. All other investments are classified as alternative investments. While alternatives include most private markets, some alternative investments, such as exchange-traded commodities and hedge funds, use strategies involving public securities. Some alternatives, such as REITs, can be held publicly, while others, like private real estate, are not listed.

The Private Markets Pathway covers investments in:

- Private equity

- Private debt
- Private special situations
- Private real estate
- Private infrastructure

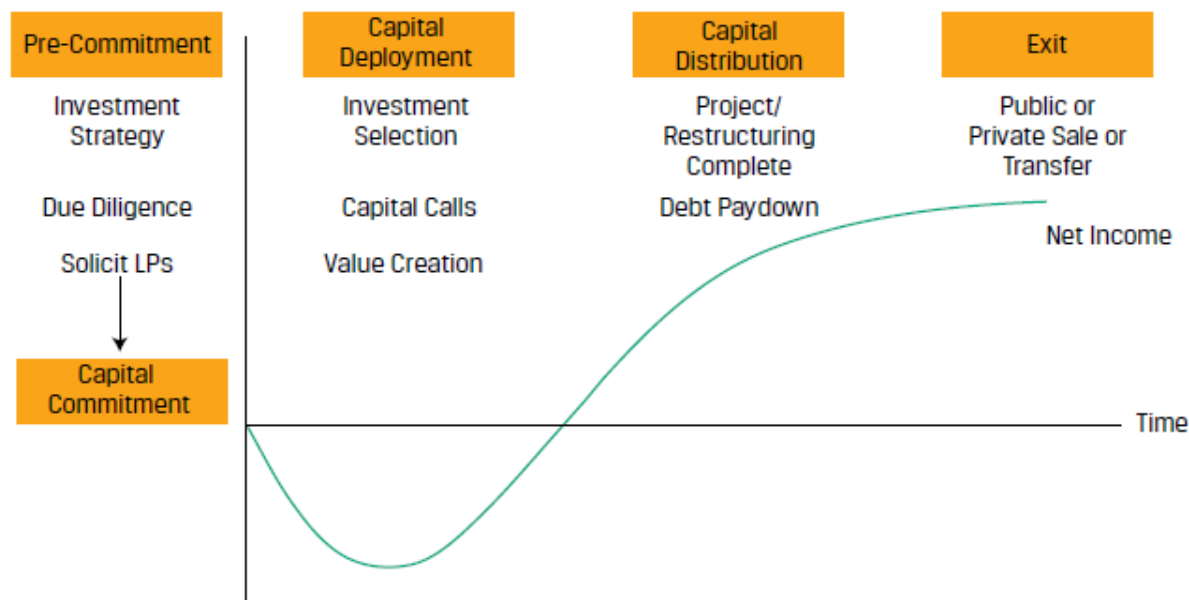
Asset Prices and Performance Measurement

Immediate access to current and historical price data is crucial for public market investment strategies, enabling investors to construct portfolios with efficient risk-return tradeoffs. In contrast, private market investors face limited price transparency. They rely on relative valuation techniques, discounted cash flow methods, and recent transactions, among other approaches, to estimate prices. Fund managers provide valuation estimates to investors with delays at less frequent (usually quarterly) time intervals, which limits the usefulness of such data for asset allocation purposes.

Public market performance metrics assume predictable cash flows, while private market investments involve far less predictable cash flows with uncertain timings. The performance metrics for private investments are discussed further in this reading.

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:



The private asset investment life cycle consists of capital commitment, deployment, distribution, and exit phases. These phases are addressed in detail in later learning modules. An important point to note is that the cycle is characterized by initial negative returns followed by cash flow and income growth, known as the J-curve effect.

Public market investors with non-controlling stakes have limited influence over issuers beyond the exercise of voting rights. In contrast, private investment managers are actively engaged throughout the investment life cycle, from target identification to managing value creation until exit.

Manager Skills

Distinct investment processes, as well as roles and responsibilities among public and private fund managers, require different skill sets for success.

Public managers focus on company research and rely on publicly available financial data for analysis. In contrast, private investments lack market price transparency and include investment opportunities ranging from real estate to startups, necessitating skills beyond security analysis. For example, real estate investments require local market knowledge, while private equity investments require operational and industry expertise.

Due to the use of less standardized contracts in private markets, both investors and fund managers must be ready to conduct additional legal analysis when considering such investments.

Venture capital investments in early stage companies with little or no revenue involve both high risk and high rate of failure. The company's initial success is often measured by non-financial milestones, such as establishing a product and go-to-market strategy. In addition to

capital, startup investors typically also provide relevant experience, contacts, and partnerships to help these startups succeed.

Portfolio Diversification Potential

Private markets and investments offer diversification potential due to their unique features, which result in low correlations with public market securities. However, unlike public markets, private markets lack observed market prices and involve longer investment periods, making it difficult to estimate correlations.

The diversification potential of private markets is evaluated differently through the following factors:

- Private company debt and equity exposures across different life cycle phases, such as rapid growth or restructuring opportunities, which are not accessible to public markets.
- The return dynamics of private company debt and equity over the investment life cycle which differ from those of mature public companies.
- Exposure to assets besides private company debt or equity that exhibit return dynamics distinct from public securities.

Exhibit 3 from the curriculum depicts the life cycle stages of companies. Firms start small, grow quickly, stabilize, and then decline.

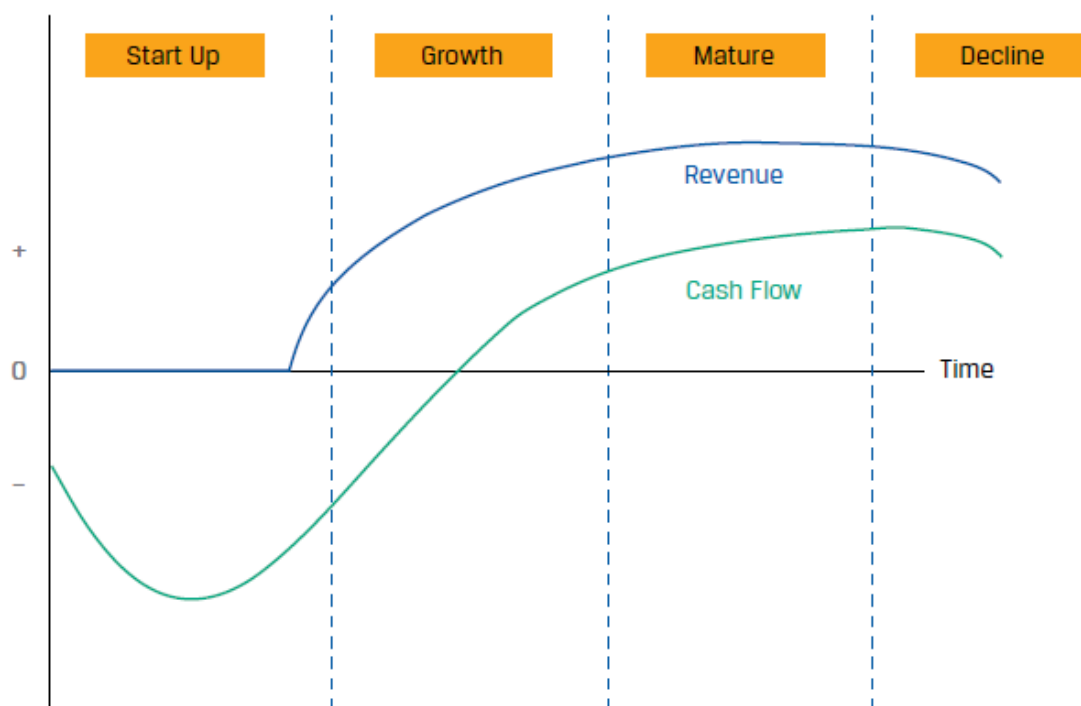


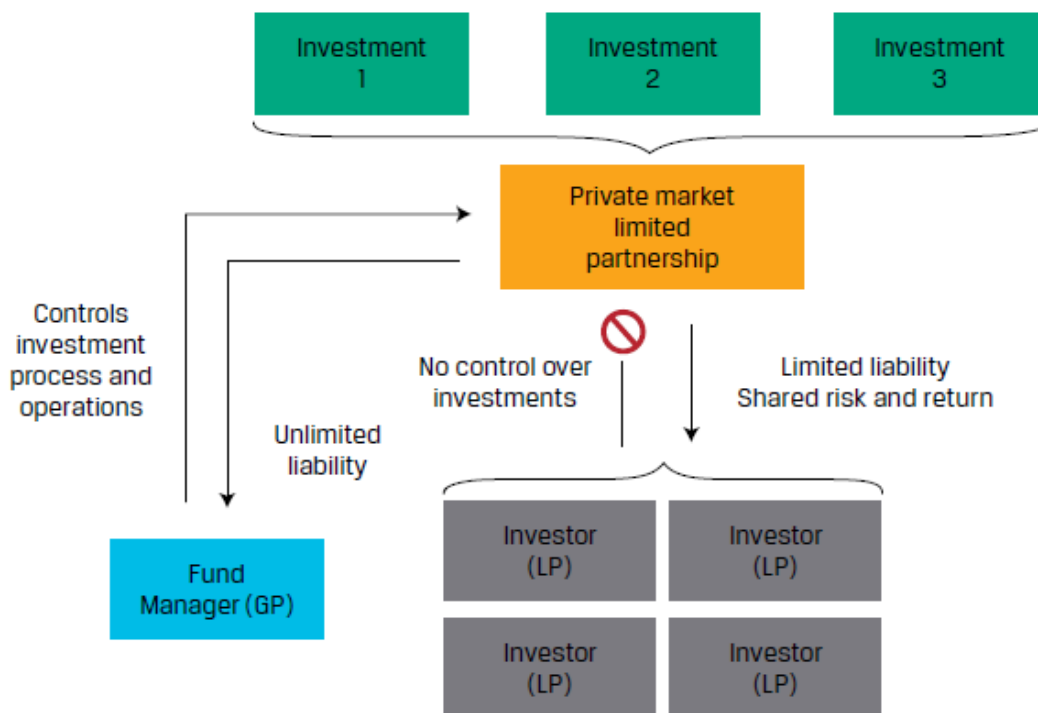
Exhibit 1 from the curriculum summarizes the features of public vs private investments.

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

3. Private vs. Public Investment Structures

The investment options in public markets are straightforward, involving either direct security selection or employing a fund manager. In contrast, private market investments are more complex.

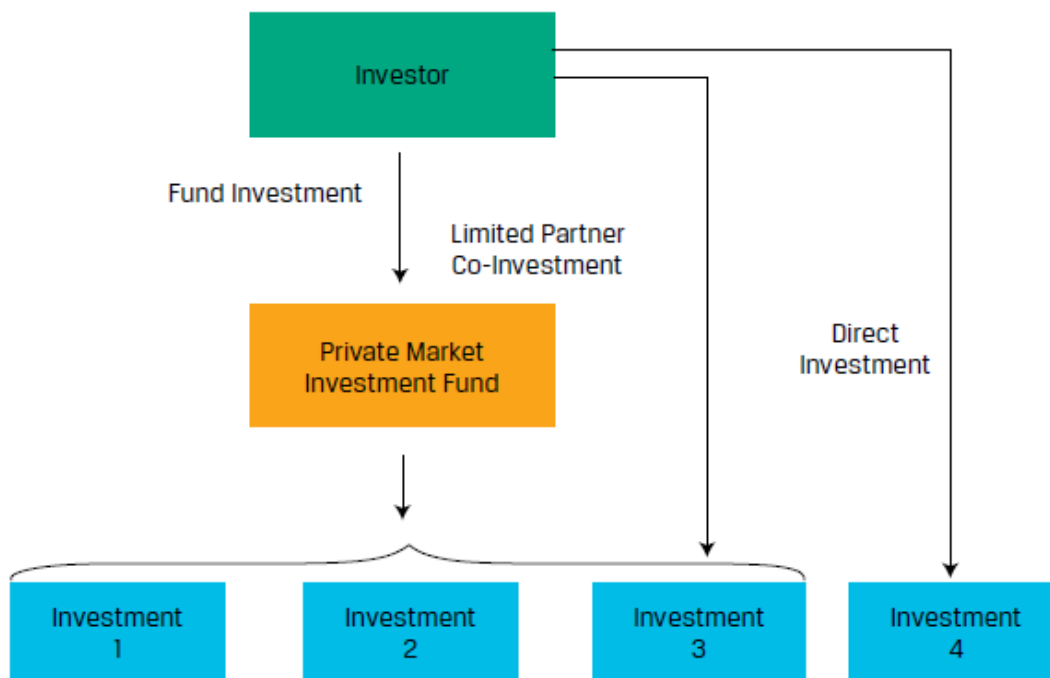
Private market investments often involve longer holding periods and active management, leading to structures like closed-end funds based on limited partnerships. This structure is illustrated in Exhibit 4 of the curriculum.



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. These three methods are illustrated in Exhibit 5 of the curriculum.



Direct Investment

Direct investment involves the purchase of an equity ownership stake or private debt investment without the use of a partner or an investment intermediary. This method is typically used by large asset owners directly purchasing significant stakes in companies or debt, and it requires substantial resources and active management.

Smaller investors (high net-worth individuals or angel investors) usually go for direct investments in startups. The relatively high failure rate of startups requires industry knowledge and experience when evaluating potential investments.

Fund Investment

Indirect investments in private market funds are often organized as limited partnerships. LPs in private market funds face long and illiquid holding periods. They are also required to commit capital in advance of investment selection and face uncertain timing of both capital calls and the distribution of returns over time. Limited partnerships often involve performance-based incentives to align manager and investor interests.

Co-investment

Co-investment allows investors to partner with others, including fund managers, to share expertise and reduce investment size. Co-investment can be done in two ways:

- Direct co-investment involves the direct purchase of an ownership stake with the use of one or more partners, one of whom may be a private fund manager.
- A limited partner co-investment involves the purchase of an ownership stake in a

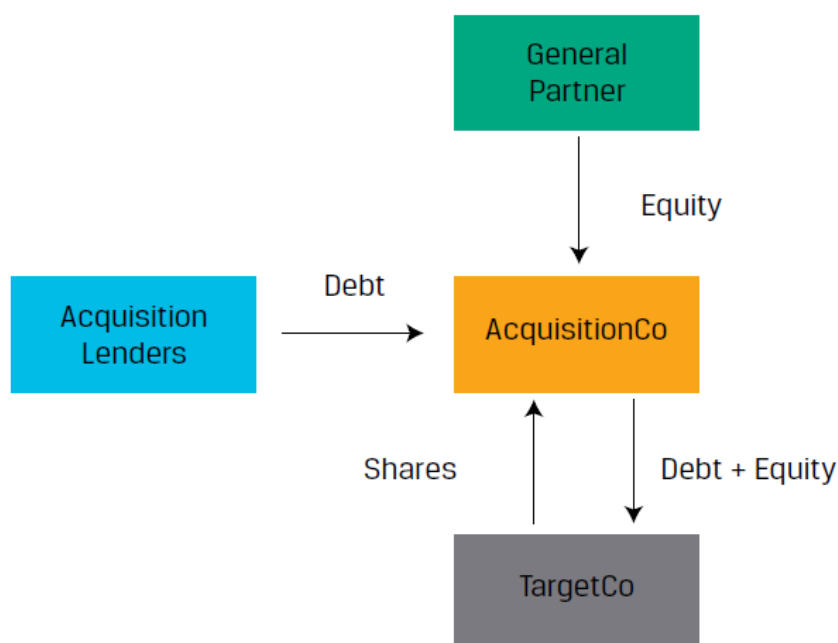
single investment that is managed by a private fund manager. This co-investment option allows LPs to take a larger stake in specific assets of interest in a portfolio under the direction of a more experienced private fund manager.

Private Investment Structures

In private markets, investment structures and governance are flexible, allowing for negotiated terms like board seats for minority investors and the creation of entities for specific deals, such as take-private transactions.

Take-private transactions, as well as other mergers and acquisitions, typically trigger the refinancing of a target company's existing debt. This situation occurs because existing lenders and bondholders are commonly protected by a change of control clause, a provision requiring the issuer to offer to repurchase outstanding debt if certain changes occur in a company's ownership or management. To acquire a company, an acquiror has to buy out not only the entire equity but also the entire debt of the company.

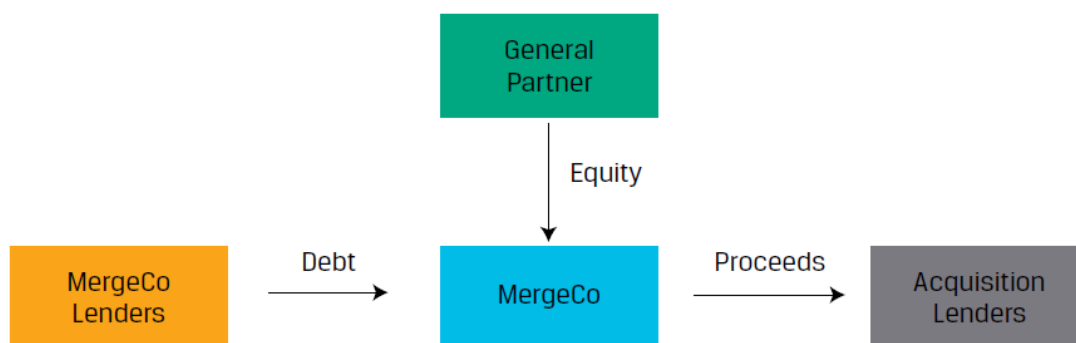
In a leveraged buyout (LBO), a new entity, Acquisition Co, is created to facilitate the acquisition of TargetCo, using a high level of debt financing alongside equity from the buyout firm. This is illustrated in Exhibit 6 below:



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. This is demonstrated in the Straploc case study from the curriculum.

Case Study

Straploc Industries Acquisition

Glidestone Capital Partners, a private equity buyout firm general partner, has targeted Straploc Industries for a take-private transaction because of its recent underperformance versus industry peers. Straploc is a manufacturer and distributor of specialty fasteners, adhesives, and seals used in numerous industrial applications that is publicly traded on the Toronto Stock Exchange. Glidestone intends to restructure Straploc's operations and sell the company in several years.

Since Glidestone plans to fund 70% of the expected CAD1.25 billion purchase price with debt and the remainder with committed equity capital, it has asked a group of banks also serving in an advisory role on the acquisition to arrange a temporary acquisition financing of CAD875 million to support its bid, pledging the Straploc shares it will acquire as loan collateral to the lenders.

Straploc Industries' New Debt Profile

Straploc Industries' management would like the ability to repay debt early as it restructures, balance both fixed and floating interest rate exposure, stagger debt maturities, and use its fixed assets as security to reduce borrowing costs.

The underwriting banks for Glidestone's acquisition loan have offered to arrange a leveraged loan for Straploc. This type of senior secured loan has a floating-rate coupon based on market reference rates, includes several restrictive debt covenants, and is prepayable.

As the buyout equity financial sponsor, Glidestone has directly solicited private investors to purchase Straploc debt and found the greatest investor interest in a mezzanine loan, or a debt claim serviced after senior debt claims but before common shares. This subordinated debt has a longer tenor and a higher fixed coupon than the floating coupon on a leveraged