

Level III of the CFA® Exam

Item-Set Questions with Answers - Private Markets Pathway - Volume 1

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Case 14: Estragon SA

Estragon SA is a French venture capital (VC) fund focused on funding innovative startup companies across Europe. The fund, established in 2010, has seen varying degrees of success in its investments, adhering to the industry-standard 100/10/1 rule of thumb. Estragon's historical data indicates a 75% failure rate among their investments, aligning closely with general VC expectations. Estragon's latest funding round aims to nurture four successful startups from its current batch.

The fund operates primarily through a closed-end limited partnership. When assessing potential investments, Estragon uses the VC method of valuation.

Q.1 Based on Estragon SA's funding structure, the general partner funds startup companies *most likely* by:

- A. Allowing investors to freely withdraw their capital at any time.
- B. Requiring investors to commit capital for a specified term.
- C. Providing liquidity through a secondary market for shares.

The correct answer is **B**.

Estragon SA operates primarily through a closed-end limited partnership. In this structure, the general partner solicits capital commitments from investors for a specified term, during which the capital is gradually deployed across multiple startups. This method requires investors to commit their capital upfront and typically locks in the investment for a period, often around ten years, aligning the interests of the general and limited partners by focusing on long-term growth and development.

A is incorrect. A closed-end limited partnership does not allow for the free withdrawal of capital. Investors are required to commit their capital for a specified term without the option of early withdrawal, providing stability and certainty in the capital available for investments.

C is incorrect. A closed-end limited partnership typically lacks a secondary market for shares, meaning that investors cannot easily sell their interests before the term ends. The focus is on long-term capital commitments rather than liquidity.

CFA Level III, Private Markets Pathway Volume 1, Learning Module 1: Private Investments and Structures LOS 1(b): Discuss private investment methods and structures and their uses

Q.2 How many startup pitches must Estragon *most likely* review to achieve four successful startups?

- A. 400
- B. 1,600
- C. 2,000

The correct answer is **B**.

With a 75% failure rate, Estragon must select around 16 startups to ensure that 4 are successful. Following the 100/10/1 rule of thumb, Estragon needs to review approximately 1,600 startup pitches. This rule implies that for every 100 pitches reviewed, 10 might receive funding, and only 1 will likely be a success.

Therefore, to achieve 4 successful startups, Estragon must review 1,600 pitches (16 startups × 100 pitches/startup).

***CFA Level III, Private Markets Pathway Volume 1, Learning Module 3: Private Equity
LOS 3(d): Estimate and interpret key inputs and calculate the value of a private equity
investment for venture capital, growth equity, and buyout situations.***

Q.3 Which type of investor is *most likely* to provide the pre-seed funding that Estragon SA relies on before reaching the seed stage?

A. Founder, family members, or friends.

B. Angel investors.

C. Venture capital funds.

The correct answer is **A**.

Pre-seed funding is typically provided by the founders, their families, or friends. At this early stage, startups have not yet established a feasible business concept, and this initial funding is crucial for developing their ideas before attracting more significant investors. Founders and those close to them are often the primary source of capital because they are willing to take the highest risk before the startup has proven its potential.

B is incorrect because angel investors usually come into play at the seed stage or slightly later when the startup has achieved some initial milestones and demonstrated basic feasibility.

C is incorrect because VC funds, like Estragon SA, typically invest at later stages when the startup has passed the pre-seed stage and shown potential for growth and scalability.

CFA Level III, Private Markets Pathway Volume 1, Learning Module 1: Private Investments and Structures LOS 1(b): Discuss private investment methods and structures and their uses.

Q.4 Which of the following statements most correctly describes how Estragon SA estimates the exit value of its investments using the VC method of valuation?

- A. Using a single estimate of revenue potential and a single estimate of price-to-sales.
- B. In the context of a range of revenue potential and price-to-sales.
- C. Using a single estimate of forecasted earnings and a single estimate of price-to-earnings.

The correct answer is **B**.

Estragon SA estimates exit value using a range of revenue potentials and price-to-sales ratios due to the high degree of uncertainty in the future performance of startups. This approach reflects the variable nature of early-stage companies and provides a more realistic and flexible valuation method. Using ranges rather than single estimates allows for better handling of the inherent uncertainties in predicting the success and profitability of startups.

A is incorrect because using single estimates does not adequately account for the high uncertainty and variability in the revenue potential and valuation multiples of startups.

C is incorrect because startups are less likely to have stable and positive earnings necessary for applying a price-to-earnings multiple, making this method unsuitable for early-stage venture capital valuation.

CFA Level III, Private Markets Pathway Volume 1, Learning Module 2: General Partner and Investor Perspectives and the Investment Process; LOS 2(e): Discuss alternative exit routes in private investments and their impact on value.

Case 15: Evergreen Capital Partners

Evergreen Capital Partners, a private equity firm, is establishing a new fund, Evergreen Fund IV, to invest in buyouts, venture capital, and growth equity. The fund is in the pre-commitment phase.

During a recent meeting, Sarah mentioned, "Private market returns are typically less reliant on price appreciation over the investment life cycle versus public market returns." Mark countered, "Once a fund's investment returns reach the amount of capital contributed, the fund reaches an IRR of zero." Linda added, "Fund returns are typically positive during a fund's capital deployment phase."

The GPs are considering an investment in TechNova, a startup requiring substantial capital for development and expansion. They believe the initial year of capital deployment will mark TechNova's vintage year. In a discussion about vintage years, Sarah stated, "A GP deploying capital over multiple years for a single fund has multiple vintage years for the fund." Mark disagreed, saying, "A GP deploying capital over multiple years for a single fund has one vintage year, defined as the final year in which capital is deployed." Linda clarified, "A GP deploying capital over multiple years for a single fund has one vintage year, defined as the first year in which capital is deployed."

The GPs also discussed the importance of aligning their interests with those of the LPs. They agreed that incorporating performance metrics and favorable terms, such as a clawback provision, would ensure fair distribution of returns and protect the LPs from paying performance fees on volatile returns that are not sustained over the full investment life cycle.

Q.1 Based on the discussion among the GPs at Evergreen Capital Partners, who made the **most accurate** statement about returns over a private market investment life cycle?

- A. Sarah Johnson
- B. Mark Thompson
- C. Linda Martinez

The correct answer is **B**.

Mathematically, when the cash inflows from investments equal the capital that was initially contributed, the Internal Rate of Return (IRR) is zero. Any returns beyond this point will result in a positive IRR, reflecting actual gains on the invested capital.

A is incorrect because private market returns are actually more reliant on asset price appreciation compared to public market returns. Private market investments typically aim to create value through operational improvements and strategic acquisitions, which enhance asset prices significantly.

C is incorrect because during the capital deployment phase, funds typically experience negative cash flows due to the initial investments and costs. Returns generally become positive during the later stages of the investment lifecycle, after value has been created and realized.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 1: Private Investments and Structures: LOS 1(b): Discuss private investment methods and structures and their uses.

Q.2 Which activity is **most likely** being conducted by Evergreen Capital Partners during the current pre-commitment phase of the private market fund investment life cycle?

- A. Implementing a strategic financing plan
- B. Identifying target investments
- C. Deployment of capital

The correct answer is **B**.

During the pre-commitment phase of a private market fund, the general partners (GPs) are primarily engaged in establishing the fund's investment strategy and identifying potential target investments. This phase involves conducting preliminary due diligence and selecting investments that align with the fund's strategy before soliciting capital commitments from limited partners (LPs).

A is incorrect. While formulating a strategic financing plan may begin in the pre-commitment phase, its actual implementation typically occurs during the commitment or deployment phases, after the capital commitments have been secured and the fund is operational.

C is incorrect. Capital deployment is not a pre-commitment activity. This phase occurs after the capital has been raised and involves investing the committed capital into the selected investments, executing the strategies laid out during the pre-commitment phase.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 2: General Partner and Investor Perspectives and the Investment Process: LOS 2(a): Discuss a general partner's roles and responsibilities in managing private investment funds.

Q.3 Based on the GPs' discussion about vintage years, who made the **most accurate** statement?

- A. Sarah Johnson
- B. Mark Thompson
- C. Linda Martinez

The correct answer is **C**.

The vintage year of a fund is defined as the initial year in which the fund's capital is first deployed. It marks the beginning of the fund's investment period and is a critical point for performance measurement and benchmarking.

A is incorrect because a fund can only have one vintage year, which is the year it starts deploying capital. Having multiple vintage years would imply multiple starting points for the same fund, which is not possible.

B is incorrect because the vintage year is defined by the initial capital deployment, not the final year. The final year may be relevant for other performance metrics but not for defining the vintage year.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 2: General Partner and Investor Perspectives and the Investment Process: LOS 2(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
