Private Markets Quiz 1

TOPIC: PRIVATE MARKETS

TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Andrew Charles is a senior advisor at Newcat Consulting Ltd., a consultancy and advisory firm that specializes in helping asset owners access private investment markets.

Charles is currently advising three new clients who have expressed an interest in increasing exposure to buyout investments in private equity markets, the details of which are presented in Exhibit 1.

Exhibit 1: Details of Three New Clients of Newcat Consulting Ltd.

Client 1 is a defined benefit pension plan with USD 5 billion of assets under management which already has a 2% allocation to private equity funds, and is looking to increase this to allocation 5%. The pension plan trustees wish to develop internal private equity investment capabilities through working closer with general partners and strengthening relationships with GPs.
Client 2 is a sovereign wealth fund with close to USD 1 trillion of assets under management which already has a decade-long track record of sourcing and structuring investments in private equity and has a well-established internal private equity investment team. Fee minimization in private investment structures is a key objective for this portfolio.
Client 3 is a university endowment with USD 20 billion of assets under management, with a 20% allocation to private equity, and is looking to increase this allocation to 25%. Having historically only acted as a limited partner in private equity funds, investment staff at the endowment do not have experience in structuring private equity deals; however, the high profile of the university will likely attract deal flow. The board of the endowment has specified that new investments should have fee reduction as a key objective.

Charles considers the following private investment methods for these clients: direct investing, direct co-investing, and indirect co-investing.

Charles meets with Dominic Ashcroft, chief investment officer for a multifamily office. Ashcroft has ample experience investing in public markets, but he expresses a wish to understand key differences between the processes of an investment manager in private markets versus public markets. In particular, Ashcroft is concerned about differences related to the following functions of investment management: active engagement, financial statement analysis and the level of legal due diligence performed on portfolio investments.

Question 1 of 11

For Client 1, **recommend** the *most appropriate* private market investment method considered by Charles (direct investing, direct co-investing, indirect co-investing). **Justify** your choice with specific reference to the situation of the client.

Explanation

Scoring key: (3 points possible)

An *indirect co-investment* is an appropriate method.

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- Entering into co-investments, where the pension plan would work alongside a general partner of a private fund when performing due diligence on co-investment opportunities, will meet the objective of working closer to the general partner and increasing the understanding of the general partner's investment process.
- The pension plan assets and allocation to private markets are relatively small and, therefore, unlikely to be easily diversified across large direct investments. Greater diversification is more likely to be achieved through indirect structures, due to the pooling of co-investments with other investors and partners.

2 points for the correct client recommendation and 1 point for a valid justification.

(Module M1.2, LOS M1.b)

Related Material

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Question 2 of 11

For Client 2, **recommend** the *most appropriate* private market investment method considered by Charles (direct investing, direct co-investing, indirect co-investing). **Justify** your choice with specific reference to the situation of the client.

Explanation

Scoring key: (3 points possible)

Direct investing is the most appropriate method.

- The sovereign wealth fund has well-developed internal resources with respect to sourcing and structuring private equity investments, meaning it is likely to be capable engaging in solo investing without the need to coinvest with a partner.
- The size of the sovereign wealth fund is large; therefore, it is likely that direct investments into buyout deals where larger positions can be taken will provide the exposure that the sovereign wealth fund needs.
- Direct investing avoids the fees of indirect fund structures, thereby meeting the object of fee minimization

2 points for the correct client recommendation and 1 point for a valid justification.

(Module M1.2, LOS M1.b)

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Question 3 of 11

For Client 3, **recommend** the *most appropriate* private market investment method considered by Charles (direct investing, direct co-investing, indirect co-investing). **Justify** your choice with specific reference to the situation of the client.

Explanation

Scoring key: (3 points possible)

Direct co-investing is the most appropriate method.

- The endowment has no prior experience in structuring private equity investment deals; therefore, it needs to work with a partner to structure deals and manage investments, suggesting co-investment is more appropriate than investing alone.
- The objective of lowering fees versus the historical investments in limited partnerships will be met through making direct investments, where management fees and performance fees will not apply.

2 points for the correct client recommendation and 1 point for a valid justification.

(Module M1.2, LOS M1.b)

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Question 4 of 11

For each of the functions of investment management listed by Ashcroft (active management, financial statement analysis, legal due diligence), **identify** whether the function is likely to be more essential, of similar necessity, or less essential in the investment management process in private markets versus public markets. **Justify** your answer. Provide each response (3) in a separate paragraph.

Explanation

Scoring key: (3 points possible)

Active management is *more essential* in private market investment than it is in public market investment management. Private equity investment is never passive — a manager is always actively executing a value creation strategy, whether it is to help a venture capital company start up, a growth equity company to grow, or refinancing and restructuring a buyout target. In contrast, public equity managers are less active in their engagement with target companies and often take noncontrolling minority stakes with little engagement with investee management.

Financial statement analysis is of *similar necessity* in private market investments as it is in public market investments. Understanding revenue, costs, assets, and liabilities of investee companies and projects is of similar importance in both types of investment markets when assessing the risks and likely returns of an investment. The exception to this is start-up companies, which lack a track record to analyze and will have a greater focus on product viability and launch.

Legal due diligence is *more essential* in private market investment than it is in public market investment management, because private investments are usually significant or controlling stakes in private assets. Investment managers need to understand how to legally structure such investments, which are often more legally complex than a noncontrolling passive public investment.

1 points for each correct function and valid justification.

(Module M1.1, LOS M1.a)

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