Private Markets

GMB Assurance (GMB) is a life insurance company looking to increase its allocation to private market investments. The investment team at GMB is experienced in allocating to public investment markets. However, the team has very little experience in private investment structures.

Peter Reber is chief investment officer of GMB. He is performing research on potential outcomes if capital is allocated to private funds. A scenario analysis is performed using the following assumptions:

- Private market returns should, even after delays in capital calls, earn an internal rate of return that is at least 2% per annum over public market returns from the date of capital commitment, due to the increased complexity and liquidity risk involved.
- The capital committed to private fund structures will not be drawn down for two years (and then is fully drawn down in a single capital call).
- Uncalled capital is invested in money market instruments yielding 3% per annum.
- The fund duration is eight years.
- The expected annual return on public markets is 8% per annum.

Reber uses the database of a private market data provider to forecast the expected rate of capital calls in buyout investments. The database shows that under normal market conditions, buyout funds are typically fully drawn down in their fourth year. Reber considers that market conditions will be relatively adverse over the coming years, with high interest rates and low economic growth.

Reber is considering how to calculate the performance of a private investment fund. He forms the following three beliefs:

Belief 1:	Due to the lack of regularly updated market values available in private equity, fund performance should be based on the IRR of cash flows.
Belief 2:	A J-curve applies twice to a private equity fund investment: once to each individual investment in the fund, and once to the fund as a whole.
Belief 3:	The IRR of a portfolio of private market investments is calculated as the weighted arithmetic average of individual investments in the portfolio.

The GMB board acknowledges that legal due diligence is likely to be a greater part of the private investment process than for an investment in public listed securities. The board asks Reber to prepare a report on the types of legal structures used in the underlying investments made in private investment funds.

Question 1 of 36

Based on the assumptions of Reber's scenario analysis, the minimum acceptable IRR to GMB for private equity investments is *closest* to:

A) 10.0%.

B) **12.4%.** ✓

C) 13.6%.

Explanation

Public markets are expected to earn 8%. Hence, given the return target of 2% over public market returns, private market investments should generate 8% + 2% = 10% per annum.

Given that capital is assumed to remain undrawn for two years and earn a return of 3%, and then be fully drawn down and earn a private market return of IRR over the next six years of the fund's life, we must have the following: $(1.03)^2(1 + IRR)^6 = (1.1)^8$.

Therefore, $IRR = [(1.1)^8 / (1.03)^2]^{(1/6)} - 1 = 12.44\ \%$.

(Module M1.3, LOS M1.c)

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Question 2 of 36

Based on the drawdown data of the private market data provider and the market conditions expected by Reber, he should forecast that any new buyout fund investment would be fully drawn down:

A) before the fourth year of the fund.

B) in the fourth year of the fund.

C) **after the fourth year of the fund.** ✓

Explanation

Adverse market conditions tend to lead to slower drawdown speeds at buyout funds. In particular, higher interest rates result in fewer investment opportunities due to greater risk aversion. Deal sourcing will take longer, while lower economic growth suggests that there are fewer opportunities for restructuring and enhancing value at target companies. Given the data provider's database shows that a buyout fund takes four years to be fully drawn down in normal market conditions, if Reber forecasts that market conditions are going to be adverse, then he should expect the fund to take longer to be drawn down.

(Module M1.4, LOS M1.d)

Related Material

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Question 3 of 36

Reber's beliefs about performance measurement in private markets are incorrect with respect to:

A) Belief 1.

B) Belief 2.

C) **Belief 3.** ✓

Explanation

Beliefs 1 and 2 are correct. Belief 3 is incorrect, as a weighted arithmetic average of the IRRs of individual portfolio investment will not give an estimate of the portfolio IRR. To calculate the portfolio IRR, all cash flows of the portfolio should be aggregated together, reflecting both their time and size. One single IRR calculation is then performed on these aggregate cash flows.

(Module M1.1, LOS M1.a)

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Question 4 of 36

To limit the liability of GMB Investors, Reber should state that any investment in real estate or infrastructure requires a:

A) direct investment.

B) change of control clause.

C) **special purpose entity (SPE).** ✓

Explanation

To limit the liability of investors in real estate or infrastructure, a special purpose entity (SPE) is usually established. Investors in the SPE are not liable for the debts or obligations of the SPE. A change of control clause is used in leveraged buyouts when the target company's debt must be refinanced. A direct investment would actually fully expose GMB to any liability of the investment project.

(Module M1.2, LOS M1.b)

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Daniel Jerry is an investment manager for Johnson Wilkinson Dawson & Co. (JWD), a private equity investment company.

Jerry is meeting with investors as part of the precommitment phase of a new fund to be launched by JWD in coming months. He meets with Gabriella Thomas, chief investment officer of a public pension scheme, who is interested in allocating to private equity investments to improve the risk-adjusted return of plan assets.

Thomas is aware that liquidity management is a significant issue for investors in private equity funds, more so than for investors in public funds. In particular, she is concerned that any deviation in the speed of drawdowns from expected speeds will likely have a negative effect on private fund performance.

Thomas wishes to calculate the impact on the returns of the private equity investment, should delays in drawdowns occur. She makes the following assumptions:

- Total fund duration is 10 years, with all investments exited at the end of the fund's life.
- Invested capital will earn a net return of 15% per annum.
- Undrawn capital will be invested in low-volatility public securities with an expected net return of 6% per annum.
- 100% of capital is drawn down in one transaction at the end of the third year of the fund's life.

Thomas is familiar with venture capital and growth equity investing from a previous role she held at a university endowment fund. However, she does not have detailed knowledge of the mechanics of buyout investing. She asks Jerry how the debt in a leveraged buyout is issued by the target investee company.

Jerry says, "A typical buyout transaction occurs in two stages. The first stage involves creating a legal vehicle, which raises long-term debt to pay off the existing providers of finance to the target company. The second stage involves merging the acquiring company with the target company once control has been established."

Thomas asks Jerry how a company like JWD accesses sensitive information about target companies to perform adequate due diligence when structuring deals.

Question 5 of 36

The concerns expressed by Thomas with respect to liquidity management could be mitigated through JWD:

A) arranging secondary market transactions in the new fund.

B) **establishing subscription lines for the new fund.** ✓

C) establishing the new fund as a continuation fund with respect to an existing fund.

Explanation

Subscription lines are short-term credit facilities that can be used by GPs to fund investments, thereby allowing the GP to make investments when opportunities arise while calling capital from LPs in a more predictable pattern.

Secondary transactions grant investors with the ability to exit a private fund, rather than to help smooth the rate of capital calls into the fund.

A continuation fund is a form is a form of secondary transaction—which, again, is designed to provide liquidity to existing fund investors rather than smooth the rate of capital calls into the fund.

(Module M2.1, LOS M2.a)

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Question 6 of 36

The loss in annual performance over the life of the fund due to capital calls being delayed as per Thomas's assumptions, relative to performance when 100% of capital is immediately drawn down, is *closest* to:

A) 2.2%.

B) **2.8%.** ✓

C) 9.0%.

Explanation

If funds are immediately drawn down and invested at the outset (time zero), then the fund would earn private equity return of 15% per annum.

If drawdowns are delayed—and, instead, assets are invested in low-volatility public securities with an expected return of 6% until Time 3, at which point they are fully drawn down into the private equity fund—the resulting per annum return is calculated as follows:

$[(1.06)^3 \times (1.15)^7]^{(1/10)} - 1 = 12.2\%$.

Therefore, the loss in annualized performance = 15% – 12.2% = 2.8%.

(Module M2.2, LOS M2.b)

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Question 7 of 36

Jerry's description of the mechanics of an LBO transaction is incorrect because the:

A) process involves one single stage, not two separate stages.

B) merger between the acquisition company and the target company happens in the first stage, not the second stage.

C) **financing raised in the first stage is short-term financing, not long-term financing.** ✓

Explanation

The mechanics of a buyout transaction involve a two-stage process. In the first stage, an acquiring company is established, with equity financing from the private equity investor and short-term debt financing raised from lenders. This capital is used to pay off existing finance providers and fund the working capital of the target company. In the second stage, the acquisition company and target company are merged, and the short-term debt is refinanced with longer-term debt for the new post-merger entity.

(Module M2.1, LOS M2.a)

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Question 8 of 36

All of the following are examples of non-public sensitive information regarding potential buyout target companies except:

A) organizational chart.

B) leasing agreements.

C) **property records. ✓**

Explanation

An organizational chart with names and positions is considered non-public information. A leasing agreement that a company may have with providers is also a non-public agreement. However, property records can be found in public databases, so that would not be considered non-public data.

(Module M2.4, LOS M2.d)

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