

Private Markets

Private Investment Structures



Exam Focus

- Understand features and characteristics of private and public markets.
- Differentiate between the methods, structures, and uses of private investments.
- Compare public and private market performance and calculate performance metrics.
- Evaluate risk and return for investing in private and public markets.

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Private vs. Public Investments

Private vs. Public Investments		
Characteristic	Private	Public
Liquidity	Illiquid (sales restricted or prohibited)	Liquid—few trading restrictions
Investment vehicle	Closed ended	Open ended
Investment process	Investment selection, value creation, exit	Security selection
Asset prices	Negotiated, estimated, little transparency	Exchange traded
Performance measurement	Compounded rates of return over holding period (uncertain timing and size of cash flows)	Periodic

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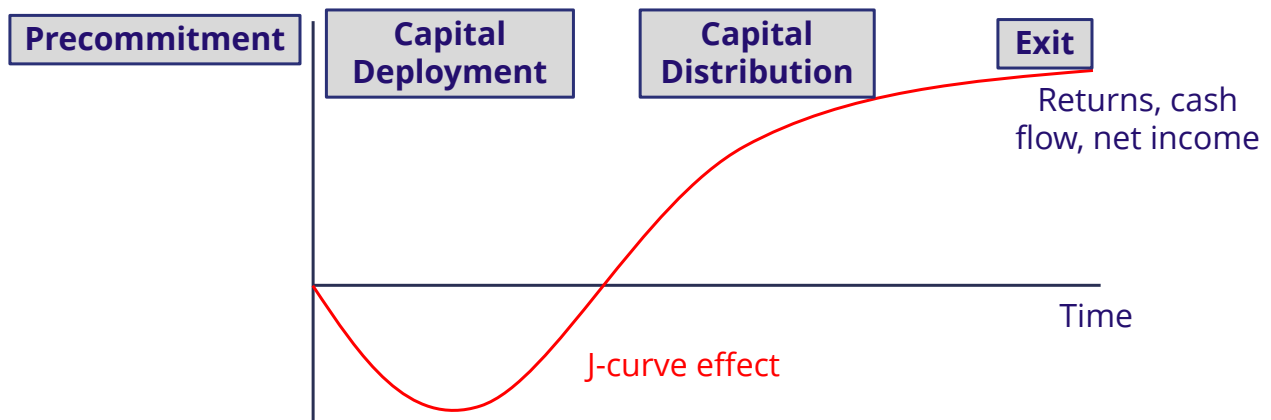
Private vs. Public Investments

(continued from previous slide)

Private vs. Public Investments		
Characteristic	Private	Public
Manager skills	Industry knowledge, managerial, technical experience, legal and financial analysis	Industry knowledge, company and financial analysis
Portfolio diversification	Life cycle phase	Dependent on correlation of periodic returns
Investments	Active management via influence or control	Passive minority interests

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Private Asset Investment Life Cycle



- Negative returns in precommitment and capital deployment phases
- Positive returns in the capital distribution and exit phases

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Management Skills

Public investments

- Public fund managers perform the research
- Investee company managers create value

Private investments

- More nuanced skills needed
 - Industry and operational expertise
 - Established relationships
 - Tax, accounting, and legal expertise
- 
- Value creation

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Diversification

Sources of diversification from private markets

- Return dynamics of equity and debt over their life cycles
- Exposures of equity and debt to growth or restructuring opportunities
- Return exposures (other than equity and debt) with different return dynamics

Venture capital: funds given to early-stage companies with minimal (or no) revenue

Buyout equity: public companies taken private in hopes of selling reorganized company at a higher price

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Question: Diversification

Which one of the following statements *best* describes a source of portfolio diversification potential from private market assets?

- A. Private markets offer potential access to higher-risk investments compared to public markets.
- B. Private markets offer potential access to investments in different company life cycle stages compared to public markets.
- C. Private markets offer the potential to invest in lower-risk companies in the mature phase of the company life cycle.

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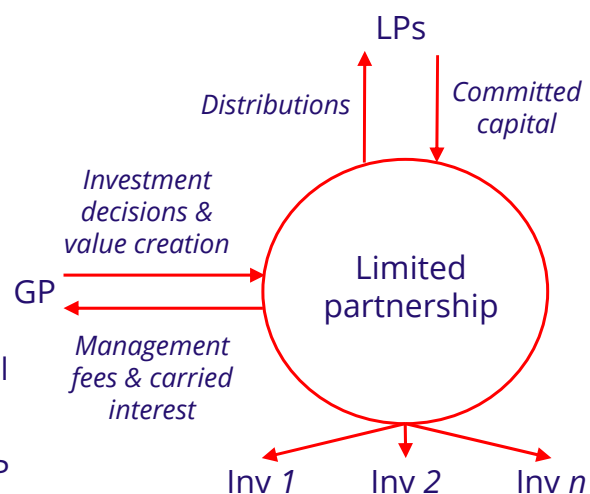
Limited Partnership Structure

General partner (GP)

- Serves as the fund manager
- Controls investment operations and processes
- Unlimited liability

Limited partners (LPs)

- Investors with no investment control
- Limited liability
- Share in returns and risk with the GP



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Direct Investments

Direct investment: purchase of a private debt or equity investment without an intermediary or partner

Co-investments

- **Direct co-investment:** direct purchase (with partners) of a private debt or equity investment
- **LP co-investment:** purchase of private debt or equity in a single investment run by a GP

Angel investors: high-net-worth investors providing early-stage financing for start-up ventures

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Indirect Investments

LP co-investments

GP

- Manages the assets and provides LPs greater access to due diligence data
- Gets expanded access to investor capital, shared investment risk, and new investors

LP

- Can own larger stake in specified asset
- Given more active role in investment process
- Exposed to long holding periods, illiquidity, early capital commitments, and uncertain timing for capital calls and distributions

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Private Investment Structures

Take-private transaction (LBO)

- Private investors purchase a public company

Leveraged buyout (LBO)

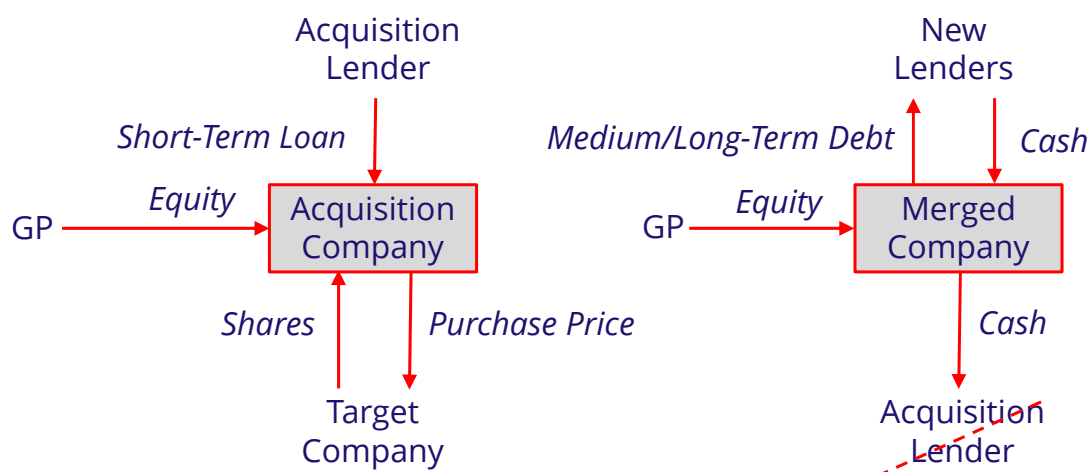
- Take-private transaction where significant short-term debt financing used to execute the acquisition
- Use of separate acquisition company

Change of control clauses

- Used to protect existing bondholders and lenders

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Take-Private Phases



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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 CAD 1.25 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 CAD 875 million to support its bid, pledging the Straploc shares it will acquire as loan collateral to the lenders.

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Case Study: 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 loan, is not prepayable, and has fewer restrictive covenants.

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Case Study: Straploc Industries' New Debt Profile

After considering both its goals and the associated trade-offs of different debt structures, Straploc management chooses to borrow using a larger (CAD 600 million) leveraged loan tranche and a smaller (CAD 275 million) mezzanine facility.

Special Purpose Entity (SPE)

- Separate legal entity from investment stakeholders
- May be established for investments in real estate or infrastructure
- Exists to facilitate the building, operations, and financing of underlying real estate or infrastructure assets
- Separates projects assets, liabilities, cash flows, and earnings from investors

Private Investment Measures of Return

Internal rate of return: the singular discount rate that produces a net present value (NPV) of zero

- Private funds have periods of +ve and -ve cash flows
- Returns best measured over a multiyear holding period
- Issue = reinvestment assumption

Return on investment (ROI): compares cash flows received to cash flows invested

$$ROI = \frac{\Sigma(\text{cash flows received})}{\Sigma(\text{cash flows paid})}$$

Ignores TVM

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

Unique case (cash flows at start and end)

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Question: Straploc Industries' ROI and IRR

After a five-year restructuring period, assume that Glidestone Partners can sell its initial CAD 375 million (equal to 30% of the original CAD 1.25 billion purchase price) equity stake in Straploc Industries for CAD 1.45 billion.

1. If we assume that Glidestone makes a single initial investment and received no dividends or distributions over the five years prior to sale, **calculate** the ROI on the Straploc equity position.

ROI = _____ =

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Question: Straploc Industries' ROI and IRR

2. Glidestone Partners has a target return of 30% over a five-year holding horizon on its buyout equity portfolio. Discuss whether the Straploc take-private transaction meets Glidestone's target and how the investment return would be affected if the investment were realized for the same amount and proceeds distributed earlier.

$$\text{IRR} = \left(\frac{\text{NPV}}{\text{NPV}} \right)^{\left(\frac{1}{\text{NPV}} \right)} - 1 = \quad \text{or}$$

The IRR of _____ exceeds Glidestone's return target of 30%. An earlier distribution of proceeds is a benefit to Glidestone's return. For example, a sale of Straploc at the end of four years results in an IRR of 40.23%. However, it is worth noting that this higher IRR assumes that the sale proceeds can be reinvested at 40.23% for an additional year.

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Elements of Private Investments

Capital

- Need for lengthy, up-front capital requirements
- Funds committed well in advance of capital deployment
- Timing and magnitude of capital calls can be variable
- Funds for commitments must be held in highly liquid, public investments

Performance

- **Vintage year:** year where capital is first deployed
- Return and timing dynamics heavily impact performance

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Question: Tenderledge Investment Fund VIII Performance

Tenderledge Partners, a private equity firm, has successfully generated capital commitments of USD 100 million for its new private market investment fund.

The fund's GP plans to deploy capital among four assets in three years, with an immediate USD 20 million invested, followed by investments of USD 40 million, USD 30 million, and USD 10 million at the end of each of the next three years.

Each investment produces three years of uniform cash inflows in the years following investment with a sale four years after initial investment. The following table shows the expected cash flows (in millions of US dollars) and IRRs for each investment asset over their respective four-year time frames.

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Question: Tenderledge Investment Fund VIII Performance

	Cash Flows by Asset					Asset IRR
	Initial Investment	First Cash Flow	Second Cash Flow	Third Cash Flow	Final Cash Flow	
Asset 1	(20)	5	5	5	30	29.1%
Asset 2	(40)	8	8	8	45	18.6%
Asset 3	(30)	3	3	3	42	15.9%
Asset 4	(10)	2	2	2	20	32.5%

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Question: Tenderledge Investment Fund VIII Performance

Tenderledge is screening candidates for an analyst position and shows the previous table along with the previous description of the fund as part of its process for eliminating applicants. In addition to the information about the asset cash flows and IRRs, the following statements are shown:

Statement 1: The arithmetic average of the project IRRs is 24.0%.

Statement 2: The weighted average of the project IRRs is 21.3%.

Statement 3: The sum of the four project cash flows produces an IRR of 21.5%.

Discuss one reason why each statement is incorrect regarding the Tenderledge fund IRR.

Solution: Tenderledge Investment Fund VIII Performance

Statement 1: The arithmetic average of the project IRRs is 24.0%.

$$\text{average} = \frac{29.1\% + 18.6\% + 15.9\% + 32.5\%}{4} = 24\%$$

Reason for lack of validity:

- Ignores the fact that the cash flows for each asset do not occur in the same period in
- Ignores the fact that cash flows for each asset are not the same

Solution: Tenderledge Investment Fund VIII Performance

Statement 2: The weighted average of the project IRRs is 21.3%.

$$\text{weighted average} = \left(\frac{20}{100}\right)29.1\% + \left(\frac{40}{100}\right)18.6\% + \left(\frac{30}{100}\right)15.9\% + \left(\frac{10}{100}\right)32.5\%$$

weighted average = 21.3%

Reason for lack of validity:

- Ignores the fact that the cash flows for each asset do in the

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Solution: Tenderledge Investment Fund VIII Performance

Statement 3: The sum of the four project cash flows produces an IRR of 21.5%.

	Initial Investment	CF ₁	CF ₂	CF ₃	CF ₄	Asset IRR
Asset 1	(20)	5	5	5	30	29.1%
Asset 2	(40)	8	8	8	45	18.6%
Asset 3	(30)	3	3	3	42	15.9%
Asset 4	(10)	2	2	2	20	32.5%
Total	(100)	18	18	18	137	

CF₀ = -100, CF₁ = 18, CF₂ = 18, CF₃ = 18, CF₄ = 137; CPT IRR = 21.5%

Reason for lack of validity = still ignores time frames

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Solution: Tenderledge Investment Fund VIII Performance

Correct methodology:

	CF ₀	CF ₁	CF ₂	CF ₃	CF ₄	CF ₅	CF ₆	CF ₇
Asset 1	(20)	5	5	5	30			
Asset 2		(40)	8	8	8	45		
Asset 3			(30)	3	3	3	42	
Asset 4				(10)	2	2	2	20
Net CF	(20)	(35)	(17)	6	43	50	44	20

CF₀ = -20, CF₁ = -35, CF₂ = -17, CF₃ = 6, CF₄ = 43, CF₅ = 50, CF₆ = 44, CF₇ = 20
CPT IRR =

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Tools to Compare Public and Private Returns

Public market equivalent (PME)

- Methods used to compare public and private market returns
- Private market IRRs reflect uneven timing of CFs
- Logic: private fund cash outflows invested into a public market index and private fund cash inflows are sold from the same index
- Used to compute terminal value
- Terminal value replaces exit value in IRR
- Challenge: choosing the appropriate public market index
- Private market fund investments should align with public market index constitution

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Question: Glidestone Partners PME

Glidestone Partners recently closed a CAD 70 million private equity fund with a four-year life. The fund's year-end cash flows, a comparable public market index, and its annual returns are shown in the following table.

Year	Glidestone Fund Cash Flow	Public Market Index	Public Market Return
0	(40)	100	N/A
1	(30)	120	20.00%
2	0	105	-12.50%
3	20	140	33.33%
4	78	150	7.14%

Glidestone fund IRR = 10.50%

Public market EAR = 10.67%

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Question: Glidestone Partners PME

Compute the PME for Glidestone's fund:

Year	PME Asset Values (CAD Millions)	Computation
0	40	
1		
2		
3		
4		

-4

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Question: Glidestone Partners PME

Evaluate whether Glidestone's fund exceeds its benchmark:

	CF_0	CF_1	CF_2	CF_3	CF_4	IRR
Glidestone fund	(40)	(30)	0	20	78	
Glidestone PME	(40)	(30)	0	20	76.07	

Note the public market compound annual return = 10.67%

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Private Market Fund Multiples

Paid-in capital (PIC): extent to which the capital drawdown phase of the life cycle is complete

$$PIC = \frac{\text{capital invested}}{\text{total capital committed}}$$

Distributed to paid-in (DPI): compares cumulative distributions to capital invested (realized return or cash on cash return).

$$DPI = \frac{\text{cumulative distributions}}{\text{total capital invested}}$$

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Private Market Fund Multiples

Residual value to paid-in (RVPI): fund's net asset value (NAV) relative to invested capital (unrealized return)

$$RVPI = \frac{\text{net asset value}}{\text{total capital invested}}$$

Total value to paid-in (TVPI): overall investment value to limited partner; also known as the multiple of money (MOM) or multiple of invested capital (MOIC)

$$TVPI = \frac{\text{cumulative distributions} + \text{net asset value}}{\text{total capital invested}}$$

$$TVPI = DPI + RVPI$$

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Question: Tenderledge Investment Return Multiples

Tenderledge Investment Fund VIII has successfully generated capital commitments of USD 100 million. The fund's GP plans to deploy capital in four stages during the next three years, with an initial USD 20 million investment followed by subsequent annual investments of USD 40 million, USD 30 million, and USD 10 million, respectively.

Based on the expected cash inflows from the four capital deployments, Tenderledge has created the following table showing fund NAV, capital called, and distributions to LPs over the next seven years.

Years	0	1	2	3	4	5	6	7
NAV		65	108	134	147	132	106	56
Called capital	(20)	(40)	(30)	(10)				
Distributed capital		0	0	0	10	25	40	60

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Question: Tenderledge Investment Return Multiples

1. **Calculate** the fund's PIC as of the end of Year 2.

Paid-in capital = _____ at the end of Year 2:

$$\text{PIC} = \frac{\text{capital invested}}{\text{total capital committed}} = \frac{\text{_____}}{\text{_____}} = \text{_____}$$

Capital invested equals _____ of the USD 100 million of capital committed, an indication that it is near the end of the drawdown phase.

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Question: Tenderledge Investment Return Multiples

2. **Calculate** and interpret the fund's DPI as of the end of Year 7.

Distributed to paid-in = _____ at the end of Year 7

$$\text{DPI} = \frac{\text{cumulative distributions}}{\text{total capital invested}} = \frac{\text{_____}}{\text{_____}} = \text{_____}$$

The fund's DPI is _____ at the end of Year 7. This result implies that LPs have realized cash distributions _____ greater than the cash invested in the fund.

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Question: Tenderledge Investment Return Multiples

3. **Calculate** and interpret the fund's TVPI as of the end of Year 4.

$$\begin{aligned} \text{DPI} &= \frac{\text{cumulative distributions}}{\text{total capital invested}} = \frac{\quad}{\quad} = \quad \\ \text{RVPI} &= \frac{\text{NAV}}{\text{total capital invested}} = \frac{\$ \quad}{\$ \quad} = \quad \end{aligned} \quad \left. \vphantom{\begin{aligned} \text{DPI} &= \frac{\text{cumulative distributions}}{\text{total capital invested}} = \frac{\quad}{\quad} = \quad \\ \text{RVPI} &= \frac{\text{NAV}}{\text{total capital invested}} = \frac{\$ \quad}{\$ \quad} = \quad \end{aligned}} \right\} \Sigma =$$

This result implies that the sum of the realized and unrealized returns to LPs is above the initial amount invested into the fund. Note that this implies a DPI of $\quad$ and an RVPI of $\quad$, indicating that most of the fund's value is unrealized.

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Key Drivers of Periodic Return for Private Market Investments

- Committed capital
- Deployed capital
- Distributed returns

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Asset Classes: Equity

Public equity

- Larger companies in the mature stage of the life cycle
- Relatively stable cash flows

Private equity

- Growth equity or early-stage venture capital
- Less stable cash flows, but the goal is higher risk-adjusted returns

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Asset Classes: Debt

Public debt

- Issued by governments or mature companies with low default risk
- Provides stable cash flows

Private debt

- May be in the following forms:
 - Direct lending
 - Venture debt
 - Mezzanine debt

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Asset Classes: Real Estate

Public real estate

- REITs provide relatively stable cash flows

Private real estate

- New development or major renovation projects
- Negative cash flows and unstable income early
- Higher returns expected for higher risk, illiquidity, longer holding periods

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Asset Classes: Infrastructure

Public infrastructure

- Mature companies
- Myriad projects generating stable cash flows

Private infrastructure

- Greenfield investments: future projects that may/may not occur
- Special situations: invest in event-driven, stressed, or distressed opportunities

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Question: Performance

Which of the following statements is most correct? Private market performance is *best* measured:

- A. over consistent time periods to benchmark against public market performance.
- B. over a multiyear holding period to assess the periodic effects of price appreciation.
- C. over a multiyear holding period because of periods of negative and positive cash flows.

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Solutions

Question: Diversification

Which one of the following statements *best* describes a source of portfolio diversification potential from private market assets?

- A. Private markets offer potential access to higher-risk investments compared to public markets.
- ☒ B. Private markets offer potential access to investments in different company life cycle stages compared to public markets.
- C. Private markets offer the potential to invest in lower-risk companies in the mature phase of the company life cycle.

Question: Straploc Industries' ROI and IRR

After a five-year restructuring period, assume that Glidestone Partners can sell its initial CAD 375 million (equal to 30% of the original CAD 1.25 billion purchase price) equity stake in Straploc Industries for CAD 1.45 billion.

1. If we assume that Glidestone makes a single initial investment and received no dividends or distributions over the five years prior to sale, **calculate** the ROI on the Straploc equity position.

$$\text{ROI} = \frac{\text{CAD 1.45 billion}}{\text{CAD 0.375 billion}} = 3.867$$

Question: Straploc Industries' ROI and IRR

2. Glidestone Partners has a target return of 30% over a five-year holding horizon on its buyout equity portfolio. Discuss whether the Straploc take-private transaction meets Glidestone's target and how the investment return would be affected if the investment were realized for the same amount and proceeds distributed earlier.

$$\text{IRR} = \left(\frac{\text{CAD 1.45 billion}}{\text{CAD 0.375 billion}} \right)^{(1/5)} - 1 = 0.3106 \text{ or } 31.06\%$$

The IRR of 31.06% exceeds Glidestone's return target of 30%. An earlier distribution of proceeds is a benefit to Glidestone's return. For example, a sale of Straploc at the end of four years results in an IRR of 40.23%. However, it is worth noting that this higher IRR assumes that the sale proceeds can be reinvested at 40.23% for an additional year.

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Solution: Tenderledge Investment Fund VIII Performance

Statement 1: The arithmetic average of the project IRRs is 24.0%.

$$\text{average} = \frac{29.1\% + 18.6\% + 15.9\% + 32.5\%}{4} = 24\%$$

Reason for lack of validity:

- Ignores the fact that the cash flows for each asset do not occur in the same time frames
- Ignores the fact that cash flows for each asset

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Solution: Tenderledge Investment Fund VIII Performance

Statement 2: The weighted average of the project IRRs is 21.3%.

$$\text{weighted average} = \left(\frac{20}{100}\right)29.1\% + \left(\frac{40}{100}\right)18.6\% + \left(\frac{30}{100}\right)15.9\% + \left(\frac{10}{100}\right)32.5\%$$

weighted average = 21.3%

Reason for lack of validity:

- Ignores the fact that the cash flows for each asset do not occur in the same time frames

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Solution: Tenderledge Investment Fund VIII Performance

Correct methodology:

	CF ₀	CF ₁	CF ₂	CF ₃	CF ₄	CF ₅	CF ₆	CF ₇
Asset 1	(20)	5	5	5	30			
Asset 2		(40)	8	8	8	45		
Asset 3			(30)	3	3	3	42	
Asset 4				(10)	2	2	2	20
Net CF	(20)	(35)	(17)	6	43	50	44	20

CF₀ = -29, CF₁ = -35, CF₂ = -17, CF₃ = 6, CF₄ = 43, CF₅ = 50, CF₆ = 44, CF₇ = 20
 CPT IRR = 21.7%

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Question: Glidestone Partners PME

Compute the PME for Glidestone's fund:

Year	PME Asset Values (CAD Millions)	Computation
0	40	
1	78	$[\text{CAD } 40\text{m} \times 1.2] + \text{CAD } 30\text{m}$
2	68.25	$[\text{CAD } 78\text{m} \times (1 - 0.125)] + \text{CAD } 0\text{m}$
3	71	$[\text{CAD } 68.25\text{m} \times 1.3333] - \text{CAD } 20\text{m}$
4	76.07	$[\text{CAD } 71\text{m} \times 1.0714]$ Terminal value

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Question: Glidestone Partners PME

Evaluate whether Glidestone's fund exceeds its benchmark:

	CF_0	CF_1	CF_2	CF_3	CF_4	IRR
Glidestone fund	(40)	(30)	0	20	78	10.50%
Glidestone PME	(40)	(30)	0	20	76.07	9.86%

Note the public market compound annual return = 10.67%

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Question: Tenderledge Investment Return Multiples

1. **Calculate** the fund's PIC as of the end of Year 2.

Paid-in capital = 90% at the end of Year 2:

$$\text{PIC} = \frac{\text{capital invested}}{\text{total capital committed}} = \frac{\$20\text{m} + \$40\text{m} + \$30\text{m}}{\$100\text{m}} = 0.9$$

Capital invested equals 90% of the USD 100 million of capital committed, an indication that it is near the end of the drawdown phase.

Question: Tenderledge Investment Return Multiples

2. **Calculate** and interpret the fund's DPI as of the end of Year 7.

Distributed to paid-in = 135% at the end of Year 7

$$\text{DPI} = \frac{\text{cumulative distributions}}{\text{total capital invested}} = \frac{\$10\text{m} + \$25\text{m} + \$40\text{m} + \$60\text{m}}{\$100\text{m}} = 1.35$$

The fund's DPI is 135% at the end of Year 7. This result implies that LPs have realized cash distributions 35% greater than the cash invested in the fund.

Question: Tenderledge Investment Return Multiples

3. **Calculate** and interpret the fund's TVPI as of the end of Year 4.

$$\begin{aligned} \text{DPI} &= \frac{\text{cumulative distributions}}{\text{total capital invested}} = \frac{\$10\text{m}}{\$100\text{m}} = 0.1 \\ \text{RVPI} &= \frac{\text{NAV}}{\text{total capital invested}} = \frac{\$147\text{m}}{\$100\text{m}} = 1.47 \end{aligned} \quad \left. \vphantom{\begin{aligned} \text{DPI} &= \frac{\text{cumulative distributions}}{\text{total capital invested}} = \frac{\$10\text{m}}{\$100\text{m}} = 0.1 \\ \text{RVPI} &= \frac{\text{NAV}}{\text{total capital invested}} = \frac{\$147\text{m}}{\$100\text{m}} = 1.47 \end{aligned}} \right\} \Sigma = 1.57 \text{ or } 157\%$$

This result implies that the sum of the realized and unrealized returns to LPs is 57% above the initial amount invested into the fund. Note that this implies a DPI of 10% and an RVPI of 147%, indicating that most of the fund's value is unrealized.

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Question: Performance

Which of the following statements is most correct? Private market performance is *best* measured:

- A. over consistent time periods to benchmark against public market performance.
- B. over a multiyear holding period to assess the periodic effects of price appreciation.
- ☒ C. over a multiyear holding period because of periods of negative and positive cash flows.

B is not correct, because the lack of traded market prices or other reliable estimates of asset values negates the ability to estimate price appreciation over shorter time periods.

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General Partner and Investor Perspectives and the Investment Process



Exam Focus

- Understand the role and responsibilities of the general partner (GP)
- Alignment of interests, management fees and carried interest
- Target investment and value creation
- The role of due diligence
- Exit values