

Basics of Investing in Private Equity Funds

Private equity is one of the three most common forms¹ of “alternative assets.” While investors may turn to alternatives in their quest for enhanced returns, successful private equity investing can be complex and challenging. Evaluating prospective funds is often more art than science, and requires specialized analysis that can take years to master... and that even then does not guarantee a profitable outcome.

This White Paper provides an introduction to investing in private equity funds², from the standpoint of an investor who is just beginning to look at opportunities in this asset class. It is a companion piece to three other Beekman Wealth Advisory, LLC White Papers on private equity investing, which provide additional detail about evaluating and choosing private equity funds; deal terms, return calculations, and governance; and fees charged on private equity funds.

The paper is divided into four sections:

- I. **Definitions:** Alternative assets, private equity, venture capital, buyouts
- II. **Life cycle** of a private equity fund
- III. The private equity difference: **Value creation** versus value discovery
- IV. Other sources of **return leakage:** Placement fees. Related-party transactions.

I. Definitions

Describing private equity as an “alternative asset” begs the question of, *Alternative to what?* So let’s start there.

Alternative assets are asset categories that are marketed as being superior alternatives³ to investments in traditional, long-only, marketable securities.

“Traditional marketable securities” means both stocks and bonds, as to which daily market prices and daily liquidity are available. “Long-only” means using vehicles in which investors hope to profit by future increases in the value of owned (held “long”) securities, as opposed to vehicles that can also “sell short” and thereby profit from market price declines.

Vehicles, such as mutual funds, investing with traditional strategies, typically eschew the use of leverage⁴, and are managed in return for a fee that is usually a stated, and more or less fixed, percentage of the assets under management. Investors in traditional marketable securities are generally passive, minority holders: They do not control, or participate in the management of, the companies in their portfolios.

Alternative assets differ from traditional assets along one or more of the dimensions described above. In the case of private equity, investors own stock in companies that are not traded on any stock exchange, and for which there is therefore no daily price or liquidity. Private equity funds often, but not always, use leverage. Private equity funds usually take large enough stakes in portfolio companies that they can at least influence, and sometimes control, their management and governance⁵. Managers of private equity funds are usually paid a share of the profits earned on investments, as well as a percentage of the value of the assets managed⁶.

There are two main “flavors” of private equity investing. Venture capitalists invest in businesses that have never been publicly traded and that are usually early in their corporate lives. Buyout specialists invest in existing businesses that usually have been publicly traded, or have been part of a larger publicly-traded entity. Venture capitalists are

¹ The other two are hedge funds and real estate.

² Investing in one-off direct private deals is a separate topic, which will not be treated here.

³ Whether they actually *are* superior alternatives is a different question.

⁴ Leverage is borrowed money, used in the hope of enhancing returns. However, leverage cuts both ways—A leveraged portfolio will decline faster in a bear market than an unleveraged portfolio.

⁵ Private equity funds may take positions ranging from meaningful minority stakes, often in conjunction with other private equity funds, to 100% ownership and full control of portfolio companies. It is common for private equity firms to appoint members of the boards of directors of portfolio companies, and to take other actions to influence or control portfolio companies’ actions.

⁶ For a full discussion of fees in private equity funds, please see the companion piece, *Investing in Private Equity: Understanding Fees*, © 2012 Beekman Wealth Advisory, LLC.

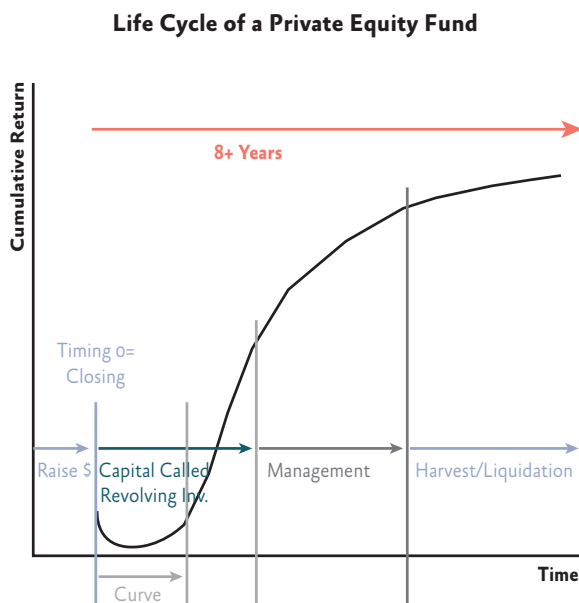
analogous to “growth” investors in traditional securities, seeking to profit from the future growth of promising businesses, whereas buyout specialists are more like “value” investors, seeking to profit by buying assets that are cheap relative to the current assets, sales, or profits of the underlying businesses⁷.

The investment case for private equity, as for all alternatives, rests on the idea that it can provide higher returns, lower risk, or both, than traditional long-only investments. Private equity certainly *does* tend to produce higher returns, and with less risk, for the *managers* of such funds—they receive much higher fees than for traditional long-only investment funds, and for much longer periods of time. The question of whether *investors* also do better with private equity is more problematical.

II. Life Cycle of a Private Equity Fund

Consider the following graphic depiction of the life cycle of a private equity fund. The most important piece of information for any prospective investor is right at the top: The life cycle of private equity funds is very long. Would-be private equity investors should never commit unless they understand thoroughly why, how, and for how long their money will be locked up.

So let’s walk through the life of a private equity fund.



The life cycle of a private equity fund begins with the decision of the would-be manager of the fund (the “General Partner” or “GP”⁸) to raise money from outside investors (the “Limited Partners” or “LPs”⁹) to invest in private deals. If the GP has not previously raised a fund to invest in the proposed strategy, the new fund will be referred to as a “first-time fund”. If there have been previous such funds, the new fund will be referred to as a “follow-on fund”.

In order to interest prospective investors, the General Partner will create a document called a Private Placement Memorandum (“PPM”), which describes the proposed investment strategy, the background of the GP, and the deal terms for the fund. This is a marketing document as well as a legal requirement, and therefore GPs will always try to “put their best face forward” in the PPM, by highlighting past success.

With the PPM and other marketing documents in hand, the GP will solicit, from prospective LPs, commitments to invest. This period of capital-raising usually lasts for months, and may entail numerous meetings with prospective LPs. Generally, the GP seeks a target minimum amount of capital, and will not legally establish the fund until that minimum is attained.

The formal legal establishment of a new fund is called a “close” or “closing”. Funds may hold more than one close. It is common to conduct a first close when the minimum amount of commitments has been secured, and one or more subsequent closes as additional investors sign on.

At closing, the investors sign formal documents that (1) legally commit themselves to invest up to their specified amount, as and when the GP asks them to do so, and

⁷This is of course a gross simplification. There are many sub-categories and permutations of both venture capitalists and buyout specialists. For example, venture capitalists may specialize by sector (for example, technology, media, or medical devices), and by the stage of development of portfolio companies (start-up to late-stage pre-IPO).

⁸Private equity funds for onshore, taxable investors, such as private individuals, are typically structured as general partnerships, as are the managing entities. Private-equity funds for offshore or tax-exempt investors, such as foundations and endowments, may be structured as corporations, but the managing entity is usually still a general partnership.

⁹Limited partners supply funds, but do not make investment decisions. In turn, their liability for losses extends only to the amounts of their commitments.

attest to their legal capacity to make this commitment, and (2) set out the terms of the agreement between the GP and the LPs. The former document is called a “Subscription Agreement”, and the latter is a “Limited Partnership Agreement” (“LPA”).

Once a closing has occurred, the GP may begin the process of investing by issuing a “capital call”, which is a formal request for LPs to send in a specified portion of their committed capital. Typically, capital calls are issued a week or so before funds are actually needed, so that LPs have time to issue funding instructions to their banks.

The GP then begins the process of deploying capital, as and when attractive investment opportunities are found. The post-closing deployment of funds is called the “Investment Period”, and often lasts for the first three to five years of the life of a private equity fund. During this period, the GP seeks companies or other assets to buy with the money supplied by the LPs.

Very often, the deal terms will specify an initial period during which the proceeds of any exited investment are put back into the “kitty” for reinvestment, rather than being returned to LPs. This period is called the “Revolving Period”. After the revolving period ends, any proceeds generated by selling off portfolio assets are returned to LPs, as “Distributions”¹⁰.

During the period after capital is called and used to buy companies and other portfolio assets, the GP will attempt to increase the value of the holdings so that they can be sold at a profit. The means of increasing value are discussed in Section III. The final period in the life of a private equity fund occurs as the portfolio is liquidated and proceeds are returned to LPs. This period typically begins three to five years after the initial investments are made, and runs until the last portfolio holding is sold.

The build-up of profits in private equity funds almost always lags the deployment of capital. In fact, private equity funds generally operate at a loss early in their lives. This period of losses is called the “J curve”, and comes about because, initially, private equity funds incur the legal, accounting, due diligence, and other expenses associated with searching for investments to buy, but don’t yet have enough (or initially, *any*) investments from which to earn profits.

Investors in private equity must be prepared, thus, to send in capital that may not be returned to them for eight or more years. Secondary markets in private equity interests are thin and generally require significant discounts to net asset value, and the consequences of failing to meet capital calls are onerous¹¹.

III. Value Creation Versus Value Discovery

Anyone who owns stock—whether or not the stock is publicly traded—wants its value to rise between the time of purchase and the time of sale. Capital gains, along with dividend distributions, are the way investors profit from owning stock.

However, GPs of private equity firms arguably have more tools with which to generate gains. Because they have influence or control over portfolio companies, they can work to *create* value, by causing company managements to pursue value-enhancing actions. Most investors in public companies—that is, managers of mutual funds and other vehicles that own minority stakes in companies and that can’t or don’t try to influence management—can only try to *discover* value, by applying superior analysis to the search for cheap stocks.

Consider the chart below. It depicts the five main reasons a private equity investment may rise in value.

How Private Equity Portfolio Companies Rise in Value:

On the Way In (=Buy Low):

1. Proprietary Deal Flow
 - Network/Reputation
 - Ready Cash
 - Skillset
2. Superior Analytical Capability
3. Capital Scarcity

During Holding Period:

4. Management of Company

On the Way Out (=Sell High):

5. Capital Abundance

¹⁰IDistributions operate like capital calls in reverse: The GP sends a letter to each LP, but instead of asking for more money to be sent by the LPs to the GP, this letter states the amount of money the GP will be sending back.

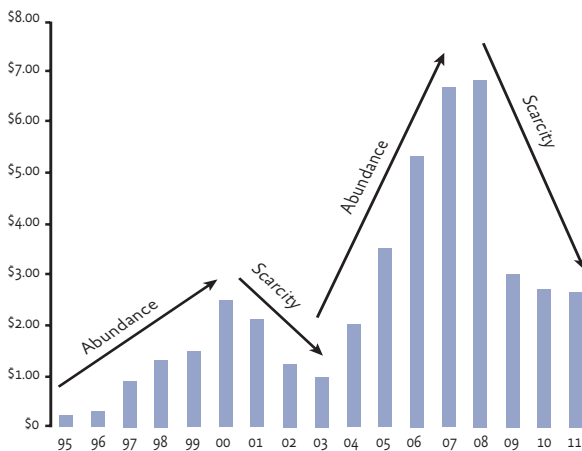
¹¹Limited partners who fail to meet a capital call usually forfeit the entire amount of their previous investment in the fund, and may become subject to legal enforcement actions by the GP.

First, a private equity investment may ultimately rise in value because, on the way in, the GP was able to buy at a cheap price. This might be because the GP’s deal flow is superior—for example, because the GP has developed a reputation for quick decisions about allocating cash, or because the GP has an extensive network of contacts who will call him with available deals first¹². It might be because the GP has superior analytical capability which allows him to see value in assets others overlook. Or it might simply be—as in late 2008 and early 2009—that investors are scared, liquidity is tight, and assets are available cheaply for *anyone* who has the courage and ability to step up and buy.

On the way out, a private equity investment can rise in price because capital is generally abundant and investors have bid up prices for assets generally. This occurred, for example, with technology start-ups in the late 1990s, and with real estate in the mid-2000s. In both cases (and in many others, previously), it was possible to sell even low-quality assets, sometimes for startling prices.

Below, for example, is a graphic depicting the amount of capital raised by private equity funds over the 16 years ending in 2011. There were two marked cycles over this period, with capital abundant in the late 1990s, during the tech bubble, and then scarce in the aftermath of the breaking of that bubble, followed by an even bigger bubble of “easy money” leading up to the 2008 market debacle, followed by a severe retrenchment.

The Capital Cycle



Global Private Equity Fundraising in \$Billions.
Source: Financial Times

There are two important points to be made with respect to entry and exit prices as a source of profit. Number one, buying when capital is scarce and selling into capital abundance works for public market participants, too. Anyone who bought, say, convertible bonds or U.S. blue-chip stocks in early 2009 made good money over the next few years—and without the burdens of high fees and illiquidity imposed by private-equity funds.

Number two, one of the most important determinants of how well a private equity fund performs is the selling conditions prevailing three to five years after a fund was raised—that is, at the point the fund begins to harvest and sell its portfolio companies. Nearly any fund in any strategy raised in, say, 2001, probably did quite well—because it was selling its companies into markets characterized by high prices and capital abundance during the mid-2000s. *Everyone* can look brilliant—under the right circumstances, for awhile.

For this reason, private equity fund returns are compared in terms of the “vintage year” in which the fund was raised. This concept is discussed further in the companion White Paper titled *Investing in Private Equity: Deal Terms, Returns, and Governance*.

So, to review the story on private equity profitability thus far: A big influence on private equity fund returns is the overall capital cycle—the scarcity or abundance of capital generally—which also affects public markets. Another determinant of private equity returns is superior analytical capability—but this isn’t exclusive to private equity, either; investors in publicly-traded equities can and do dig deep to uncover value.

So what, then, *is* different about private equity? How *do* private equity GPs create value (if indeed they do)? It is largely through the actions taken by GPs during the holding periods of portfolio companies.

From their position of influence or control, GPs may, for example, be able to replace portfolio company management; shut down losing ventures and pursue promising

¹²It is not necessary to be a private equity GP to have these characteristics, of course. To cite the obvious example, Berkshire Hathaway’s ready cash and the reputational benefits of a Berkshire Hathaway investment give Warren Buffett the ability to negotiate exceptionally attractive deals.

ones; introduce ideas and people who may be useful; and take similar steps to build up company value. In some cases, GPs may have managed many companies through turn-arounds, or have nurtured many start-up entrepreneurs through the transition from promising idea to profitable product. In others, GPs may have operating skills in particular fields, such as technology or media, perhaps as a result of having previously been entrepreneurs themselves.

These *are* differentiating skills, and—along with proprietary deal flow—may be well worth paying for. The challenge for the would-be private equity investor (the LP) is to determine how much of a GP’s track record rests on such differentiated skills, and how much on luck or external-determined factors, such as the capital market cycle.

How does a prospective LP make that determination? By interviewing the general partner, if possible, and by reviewing the PPM, certainly. The next White Paper in this series, *Investing in Private Equity: Evaluating the Investment Premise*, discusses what to look for when you do.

IV. Summary and Take-Aways

No investor is ever obligated to invest in private equity, and, given high fees and long lock-ups, should probably do so only when the particular opportunity on offer looks compelling. Before committing to any private equity fund, investors should be able to affirm the following:

1. I do not and will not need access to the money I am considering committing to private equity.
2. I know where we are in the capital market cycle, and I am confident I am not buying into a bubble.
3. I understand why and how the private equity strategy I am considering makes money, and I am comfortable that this strategy is sustainable.
4. I know what the principals of the particular fund I am considering bring to the table, and I have a clear sense of why portfolio company managements would consider them attractive business partners.

Even if the answers to all of these questions are satisfactory, there are still more hurdles to commitment before

the savvy LP signs up. These come in the form of the fees and deal terms, which govern the distribution of risks and returns between the GP and the LPs. Those topics are the subjects of the Beekman Wealth Advisory, LLC White Papers titled, *Investing in Private Equity: Understanding Fees and Investing in Private Equity: Deal Terms, Returns, and Governance*.



Elizabeth P. Anderson, CFA, is the founder of Beekman Wealth Advisory LLC, a boutique financial consultancy providing highly customized services to families and individuals. Founded in 2003, Beekman Wealth Advisory's business model reflects its unwavering commitment to the best interests of its clients.

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⁸It is not possible to make an exhaustive list of return leakages, as new fees can always be invented. Investors should heed warnings to read the offering documents carefully before committing to invest.

⁹The private placement memorandum will have a disclosure section, usually toward the back, covering conflicts of interest. Some conflicts of interest—such as conflicts in the allocation of time, when a GP is managing more than one fund—are relatively innocuous. In general, however, the longer the section disclosing the conflicts of interest, the wavier investors should be.

¹⁰There was also an incentive fee in place, but it was moot, because the fund lost money.