STEPSTONE
inside private markets

A Comprehensive Guide to Private Equity Investing

Private equity is a US$4.3 trillion global industry[1] that entails investing in non-public companies through privately-negotiated transactions and results in the private ownership of businesses. The industry has grown exponentially over the past 30 years.

While most private equity transactions involve investments in private companies, they can range from the financing of start-up entities, to infusing growth equity into an expanding company, to buying out mature public or private enterprises. What is common to most private equity investments is that the investor group often acquires a large or significant ownership stake in the company through a highly structured and negotiated transaction.

Typically, private equity managers take an active role in monitoring and advising their portfolio companies. Through this "hands-on" approach, private equity managers seek to create value and enhance returns by directly influencing a company's strategy and performance, as well as the timing of the exit from the investment, whether through a sale to a strategic (e.g., a corporation) or financial buyer (e.g., another private equity firm) or via an initial public offering ("IPO").

[1] Forbes, May 2017.

May 2017

The Mechanics of Investing

The mechanics of private equity investing are illustrated in **Figure 16**. Most private equity investors[5] access the asset class through capital commitments to private equity limited partnerships. These limited partnerships then make direct investments in companies or funds (e.g., funds of funds).

GENERAL PARTNER/LIMITED PARTNER RELATIONSHIP

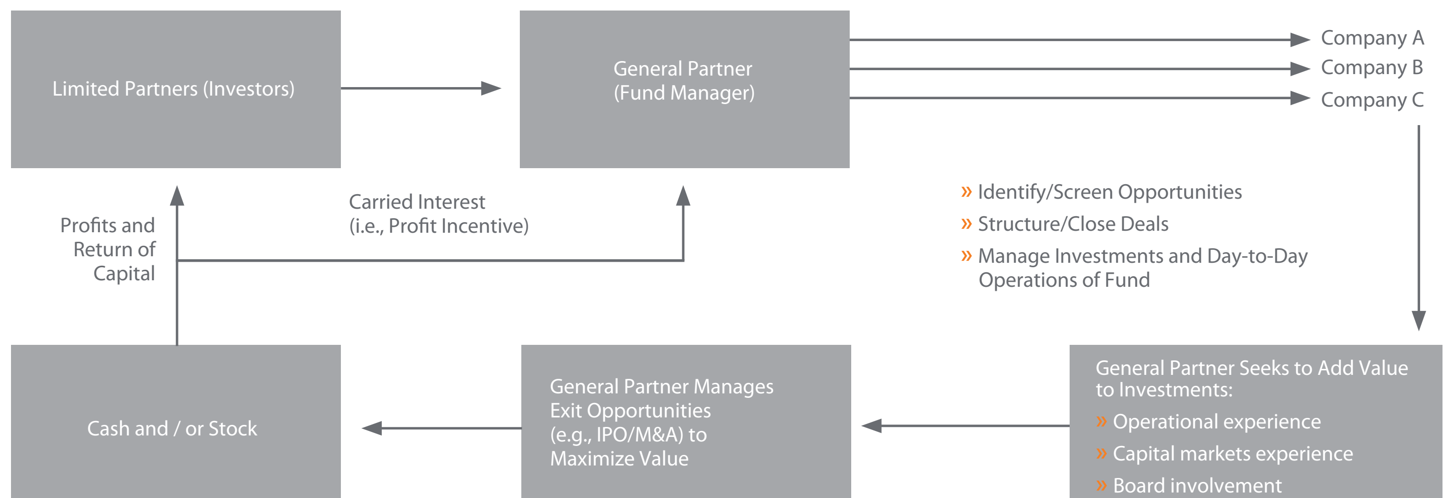
The manager of a partnership is called the "general partner," while the individuals and institutional investors who provide the majority of the capital are called the "limited partners." Typically, the general partner will also contribute at least 1% of total commitments raised to the partnership, and principals of the firm may also invest additional personal capital in the fund.

The general partner is responsible for reviewing investment opportunities and has authority over investment decisions. Limited partners have no discretion over investment decisions and do not take part in day-to-day management activities.

CAPITAL CALLS

In a private equity partnership, capital is drawn down from the limited partners in a series of events known as "capital calls." Private equity managers generally only call capital when they are ready to make an investment. Calling capital without making an investment acts as a "cash drag" on performance. Since fund managers are compensated on performance, they are motivated to closely match capital calls with their investment pace.

FIGURE 16 | HOW A PRIVATE EQUITY PARTNERSHIP WORKS



[5] To invest in private equity, a US citizen generally must be a Qualified and Accredited Investor. Qualified Purchasers include individuals and family entities with minimum net investment assets of $5 million or other entities with minimum net investment assets of $25 million (e.g., corporations, public foundations and endowments). An individual Accredited Investor must have a minimum net worth of $1 million or a gross income in excess of $200,000 (or joint income with the investor's spouse in excess of $300,000) in each of the two previous years and must reasonably expect to maintain that level of income for the current year. An entity Accredited Investor generally must have total assets of $5 million or more.

The period of time in which the partnership is allowed to make new investments is called the "investment period." Most funds have five- to six-year investment periods that begin once operations commence. Thereafter, the manager usually reserves the right to draw down uncalled capital only to make follow-on investments and cover expenses.

Limited partners are contractually obligated to honor their capital calls as dictated by the terms of the limited partnership agreement. Investors who default on their capital commitments can lose their entire interest in the partnership and are subject to potential legal action by the general partner to collect the unfunded portion of their commitments.

MANAGEMENT FEES AND PROFIT INCENTIVE

In most private equity partnerships, a general partner receives a management fee and a percentage of the profits or "carried interest." Typical management fees run between 1.5% and 2.5% of total capital commitments per year during the commitment period. Thereafter, the base amount on which a management fee is calculated is typically reduced by the cost of realized investments (i.e., the management fee is charged on "invested capital"). In addition to a management fee, a general partner will also earn a carried interest, which is a profit incentive for the general partner (typically 20% of gross profits, although some firms take as much as 30%).

The carried interest is intended to provide the manager with the bulk of its compensation and helps align its interests with those of the limited partners. Many funds also have a "preferred return" feature, which is the minimum IRR that the manager must generate for investors before sharing in profits. The preferred return ensures that the private equity manager will share in the profits of the fund only to the extent that the investments perform at a minimum "acceptable" level, commonly 7-8% for LBO funds. If a manager does not exceed the fund's specified preferred return, it is not entitled to take its carried interest.

In addition, most private equity partnerships have what is called a "clawback" provision, which requires the partnership to undergo a final accounting of all of its capital distributions when the fund is concluded. This task is designed to ensure that the general partner receives no more than its contractual share of the profits. A clawback goes into effect when it is found that the general partner has taken too much carry, a situation that typically arises when there are realized gains on early investments and significant losses on later investments.

Finally, private equity firms may charge fees to their portfolio companies. These fees often represent advisory, transaction, break-up, monitoring and/or other related fees. Most private equity managers will offset a portion of the management fees they charge their limited partners with the fees they earn from their portfolio companies.

RECALLING AND RECYCLING OF CAPITAL

It is common for private equity funds to contain provisions in their terms that permit them to recycle capital. Funds generally have the option to recycle capital in two situations. First, funds may have the ability to reinvest (i.e., "recycle") the cost basis of investments realized within a certain time frame (typically 12 months from the date of initial investment). The ability to recall the capital for reinvestment is generally confined to the time period encompassing the investment period of the fund (typically the first 5-6 years of the partnership). Second, funds may have the ability to reinvest distributions up to the amount of management fees paid to the fund by its limited partners. It is important to note that recycling capital in either case has no impact on the amount of an investor's original commitment to a private equity fund. Recycling capital has the practical effect of potentially increasing the amount of invested capital (above the investor's capital commitment) without a commensurate increase in fees, because fees are capped as a percentage of capital commitments—with capital commitments always remaining constant regardless of the ability to recycle. Recycling provisions may be beneficial to investors, as they enable investors to have additional capital at work, beyond their capital commitment, without an increase in fees (see **Figure 17**).

FIGURE 17 | POTENTIAL BENEFITS OF RECYCLING CAPITAL ON EFFECTIVE FEES PAID

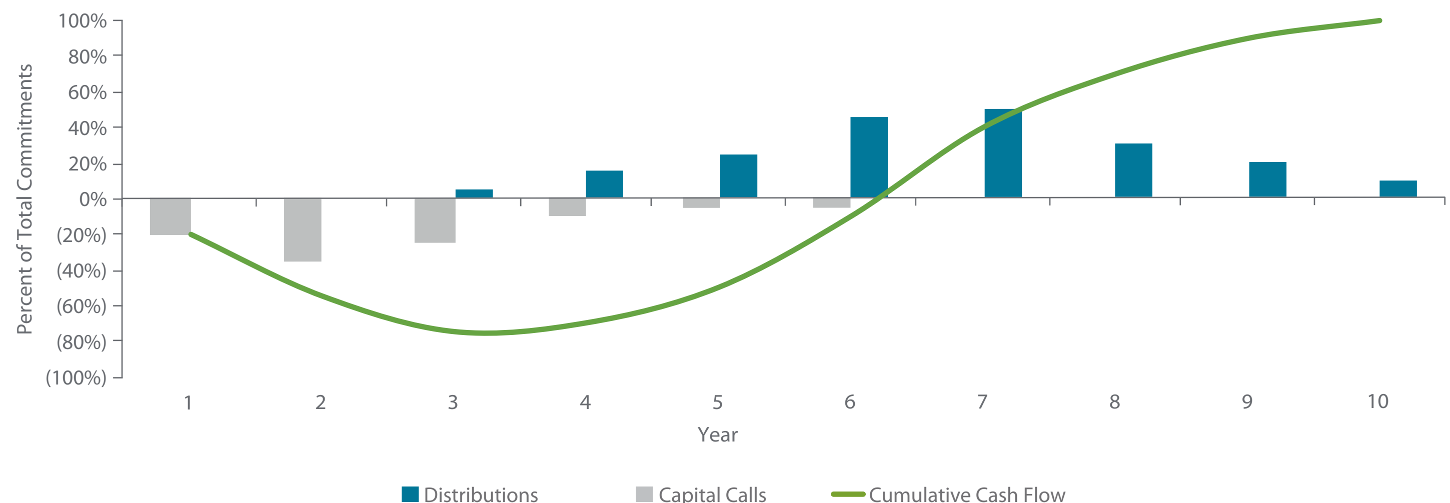
Assumptions	» $100 Capital commitment » 1.5% Management fee on capital commitment during the investment period » Cost basis of investments realized with 12 months of investment date can be reinvested within the fund's investment period » Example below assumes the fund is still operating within its investment period
Hypothetical Example	» $100 Capital commitment » $100 Capital called from investors ($100 is the maximum investor capital outlay) » $10 Recycled capital (re-invested cost basis of deals realized within 12 months of initial investment date) » $110 Total capital invested » 1.36% Effective management fee on total capital invested assuming recycling of capital » 1.50% Effective management fee without the ability to recycle capital

Source: StepStone analysis.

PRIVATE EQUITY CASH FLOWS

In the early years of the life of a fund, the cash flows are predominantly negative for investors as cash is called by a partnership. In the latter years of a fund, cash begins to flow back to investors in the form of distributions from realized investments, assuming that portfolio companies are sold and profits are realized. The typical holding period for a portfolio company investment in a private equity fund is three to five years before it is realized. Prevailing economic and capital market conditions will also influence the holding period. **Figure 18** illustrates hypothetical cash flows for a typical private equity partnership.

FIGURE 18 | HYPOTHETICAL CASH FLOWS OF A PRIVATE EQUITY PARTNERSHIP



Source: StepStone Analysis.
Note: This chart is provided for illustrative purposes only and is not reflective of any actual fund or investment. The chart assumes a 1.9x return multiple over ten years, which represents an IRR of 15.2%.

Summary

Private equity investing can play an important role in a well-diversified portfolio. It seeks to achieve excess risk-adjusted returns through value-added investing that exploits market dislocations and unique business opportunities. Private equity investments have significantly outperformed the broader public equity markets over 10- and 20-year trailing periods and have the potential to provide investors with the opportunities to diversify their portfolios outside of traditional markets. However, because of the nature of private equity investments extreme care and diligence should be taken when making such investments. Information is less widely disseminated, risks can be difficult to evaluate and investments may be illiquid for many years. These characteristics highlight the importance of accessing this asset class through experienced and diligent private equity teams. Investing in this asset class is intended for investors who are willing to bear the high economic risks of the investment in pursuit of superior returns. Of course, past performance is no guarantee of future results and real results may vary.

Private Equity Glossary

A

» **Accredited Investor** – An individual Accredited Investor must have a minimum net worth of $1 million or a gross income in excess of $200,000 (or joint income with the investor's spouse in excess of $300,000) in each of the two previous years and must reasonably expect to maintain that level of income for the current year. An entity Accredited Investor generally must have total assets of $5 million or more.

» **Angel Investor** – A wealthy individual, commonly an entrepreneur, who provides backing to businesses or business concepts in their very early stages.

B

» **Board Seats** – Private equity firms often acquire board of director positions of the companies in their portfolios, thus giving these firms a means of monitoring and managing the companies in which they have invested.

» **Bridge Financing** – Temporary funding that "bridges" the time between receipt of the bridge financing and when it is eventually replaced with permanent capital.

» **Buyout** – see "Leveraged Buyout"

C

» **Capital Account Statement** – A statement of each limited partner's pro rata share of the partnership's profit, loss, income and assets.

» **Capital Call** – When a private equity fund manager (usually a general partner in a partnership) requests that an investor in the fund (a limited partner) provide additional capital. Usually, a limited partner will agree to a maximum investment amount, and the general partner will make a series of capital calls over time to the limited partner as investment opportunities arise. Most general partners call down capital only as they require it, rather than draw it down in preset amounts according to a rigid timetable. Capital may also be called to cover fund expenses.

» **Carried Interest** – Carried interest, also referred to as "carry" or "promote," is the share of the partnership profits received by the general partner, with 20% carried interest as the industry standard (although it can be higher or lower in certain cases and varies whether a fund of funds or single-manager fund). The remaining 80% is retained by the limited partners.

» **Cash Multiple** – Also known as Return Multiple (see "Distributions to Paid-In Capital")

» **Catch-Up Period** – Once the general partner provides the limited partners in a fund with their preferred return, if any, the catch-up period begins, during which the general partner receives the majority or all of the profits until the agreed-upon profit split (as determined by the carried interest) is reached.

» **Clawback** – The clawback provision is a common term found in a private equity partnership agreement that requires the partnership to undergo a final accounting of all of its capital distributions when the fund is concluded. This task is designed to ensure that the general partner receives no more than its contractual share of the profits. A clawback goes into effect when it is found that the general partner group has taken too much carry, a situation that typically arises when there are realized gains on early investments and significant losses on later investments.

» **Co-Investor** – Although this term is loosely interpreted to mean any two parties investing alongside each other in the same company, in the context of limited partners in a fund, it carries a highly specific meaning. A limited partner in a fund who has co-investment rights can invest directly in a company that is also backed by the fund managers. In this way, the limited partner ends up with two separate stakes in the company: the first indirectly through the private equity fund to which the limited partner has contributed; the second through its direct investment. Some private equity firms offer co-investment rights to encourage limited partners to invest in their funds.

» **Commitment** – A limited partner's obligation to provide a certain amount of capital to a fund. The period in which an investor's obligation to contribute capital to the private equity fund for investment purposes—typically, the first four to five years of the term of the fund—is called the "commitment period."

» **Compound Annual Growth Rate ("CAGR")** – The year over year growth rate applied to an investment or other aspect of a firm using a base amount.

D

» **Deal Flow** – The rate at which a fund reviews the number of potential investments in any given period.

» **Distressed Debt** – A private equity or hedge fund investment strategy that involves the purchase of debt securities trading at a significant discount to par value.

» **Distributions** – Cash or stock returned to the limited partners after the general partner has exited from an investment. A stock distribution is sometimes called an "in-kind" distribution.

» **Distributions to Paid-In Capital (also known as "Cash Multiple" or "Return Multiple")** – The amount a partnership has distributed to its investors relative to the total capital contribution to the fund. Return multiples, coupled with IRRs (see definition), are typical performance metrics used in evaluating private equity investment performance.

E

» **Early Stage** – A fund investment strategy involving investment in start-up companies for initial product development, marketing, manufacturing and sales activities.

» **Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA")** – A measure of a company's cash flow, calculated by looking at earnings before the deduction of interest expenses, taxes, depreciation and amortization. EBITDA is often used as a measure of financial performance for leveraged companies, such as those that have undergone a leveraged buyout.

» **Exit** – The means by which a private equity firm realizes a return on its investment. This typically comes when a portfolio company goes public, or when it merges with, or is acquired by, another company.

F

» **Financial Buyer** – This term typically describes private equity managers or financial institutions that purchase companies or assets for purposes of reselling them for a profit at a later date.

G

» **General Partner** – Term used to distinguish the firm that is managing the private equity fund on behalf of the limited partners (i.e., the individuals or the institutional investors who provide capital to the fund).

» **General Partner Contribution** – The amount of capital that the fund manager contributes to its own fund in the same way that a limited partner does. This can be an important way in which limited partners can ensure that their interests are aligned with those of the general partner.

» **Growth Stage (also known as "Middle Stage")** – A fund investment strategy involving financing for a company that has received one or more rounds of financing and is generating revenue from its product or service.

I

» **Internal Rate of Return ("IRR")** – The IRR is a measure of private equity performance. IRRs are determined by the amount and timing of cash inflows and outflows, as well as the residual value of investments at the end of the measurement period. Gross IRR refers to the rate of return before management fees, expenses, and carried interest. Net IRR refers to the rate of return after management fees, expenses and carried interest. There are several different methodologies for computing IRRs. Two popular methods are the "calendar time" and the "time zero" methods. The "calendar time" approach (sometimes called "dollar-weighted" in the private equity industry press) entails lining up all drawdowns and returns of capital in the year

(or quarter, month or even the day) during which they occurred. The "time zero" method assumes that all investments are made at the inception of the fund. These different methods can produce dramatically different IRRs.

J

» **J-Curve** – The J-Curve is a term used to describe the impact of management-fee drag and potential writedowns of underperforming portfolio companies on the performance of a private equity fund early on in the fund's lifecycle. These combined effects generally cause performance (as measured by IRRs) to dip down, taking the shape of the letter "J," in the early years of the life of the fund when most of the portfolio is typically held at cost.

L

» **Later Stage** – A fund investment strategy involving financing for the expansion of a company that is producing, shipping and increasing its sales volume.

» **LBO (Leveraged Buyout)** – A fund investment strategy typically involving the acquisition of a relatively mature product or business, from either a public or private company, utilizing a significant amount of debt (typical LBO transactions today are funded with about 30%-40% equity and 60%-70% debt).

» **Lead Investor** – The firm or individual that organizes a round of financing and usually contributes the largest amount of capital to the deal.

» **Leverage** – The use of borrowed money to acquire assets, build operations and increase revenues. By using debt, a company attempts to achieve these results faster. But if the company underperforms, it may be at risk of not being able to make payments on the debt.

» **Limited Partner(s)** – Institutions or individuals contributing capital to a private equity fund. Limited partners typically are pension funds, private foundations, university endowments and high net worth individuals.

» **Limited Partnership** – The legal structure used by most private equity funds, usually fixed-life investment vehicles. The general partner or management firm manages the partnership using the policy laid down in a partnership agreement, which also covers terms, fees, structures and other items agreed upon between the limited partners and the general partner.

M

» **Management Buy-Out (MBO)** – The acquisition of a company by its management, often with the assistance of a private equity investor.

» **Management Fee** – An annual fee, typically a percentage of limited partner commitments to a fund, appropriated to cover the basic costs of running and administering a fund. Management fees tend to run in the range of 1.5% to 2.5% per year. In the later years of a partnership, these fees are often scaled down to reflect the reduced workload of the general partner. Unlike carried interest, management fees are not intended to be primary sources of incentive compensation for investment teams.

» **Mezzanine Financing** – Mezzanine financing can have different meanings as it relates to both VC and buyouts. With respect to VC, mezzanine financing can be defined as an investment provided to a company that is already producing and selling a product or service, for the purpose of helping the company achieve a critical objective that will enable it to go public. Within the context of buyouts, mezzanine financing is an investment strategy involving subordinated debt (the level of financing senior to equity and below senior debt).

N

» **NASDAQ Composite** – The NASDAQ Composite is an unmanaged stock index with an emphasis on technology-oriented companies. Investing in the NASDAQ Composite is subject to sector risk as well as the general risks of equity investing, which include, among others, market risk and the volatility of returns.

O

» **Overhang** – Private equity capital that has already been raised but has yet to be invested.

P

» **PIPEs** – An acronym for "private investing in public entities." The term specifically denotes a private investment in a publicly held company.

» **Portfolio Company** – The term used to describe an investment in a company held by a private equity manager.

» **Preferred Return** – The preferred return is the minimum annual IRR sometimes provided to the limited partners before the general partner shares in profits. In effect, the preferred return ensures that the general partner will share in the profits of the partnership only to the extent that the investments perform at a minimum "acceptable" level.

» **Pre-Money Valuation** – Typically, a VC valuation metric that refers to the value of a company before an investor's money is invested. It is usually contrasted with post-money valuation that combines a company's pre-money valuation with the value of the money invested. For example, a company with a pre-money valuation of $10 million that receives $5 million in investment would have a post-money valuation of$15 million, consisting of the $10 million pre-money value of the company plus the $5 million invested.

» **Private Equity** – Negotiated and often highly structured private investments in companies in return for an ownership interest. Private equity investments are generally illiquid and, as such, are considered long-term investments. Private equity is composed of, but not limited to, the following subcategories: leveraged buyouts, VC, mezzanine debt financing, distressed debt, real estate, development capital and special situations.

» **Private Placement** – This term is used specifically to denote a private investment in a company that is publicly or privately held.

» **Purchase Multiple** – Typically, a buyout valuation metric that refers to the multiple of cash flow (i.e., EBITDA—earnings before interest, taxes, depreciation and amortization) that a private equity firm pays in the acquisition of a company.

Q

» **Qualified Purchaser** – These include individuals and family entities with minimum net investment assets of $5 million or other entities with minimum net investment assets of $25 million (e.g., corporations, public foundations and endowments).

R

» **Ratchet** – A provision that enables a VC firm to maintain its percentage ownership in a company despite the company's future issuance of additional shares to other entities.

S

» **Schedule K-1 Statement** – The Internal Revenue Service form sent to investors by a partnership, which provides the flow-through income and expenses to be reported on an investor's individual tax return.

» **Seed-Stage Investment** – Seed rounds are initial rounds invested in companies at very early stages of development, typically with the founders and product developers on board but without a complete management team in place.

» **Standard & Poor's 500 Index** – The Standard & Poor's 500 Index ("S&P 500") is a capitalization-weighted index of 500 stocks trading in US equity markets. Performance is calculated on a total return basis.

» **Strategic Buyer** – This term typically describes larger corporations that purchase smaller companies or assets that relate to their core group of businesses. Strategic buyers can often extract synergies from the purchase of complementary assets. Private equity managers can sell their portfolio companies to strategic buyers as a means of realizing their investment.

V

» **Venture Capital** – Venture capital typically refers to money provided by investors to development-stage, privately held companies that are early in their life cycle with perceived high growth potential.

» **Vintage** – A term used to describe the year of fund formation and first takedown of capital. The concept of vintage year is used when benchmarking the performance of different private equity funds.

W

» **Write-down** – A reduction in the value of an investment.

» **Write-off** – The write-down of a portfolio company's holdings to a valuation of zero, in which case the private equity investors receive no proceeds from their investment and the investment is usually removed from the fund's portfolio.

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The Firm creates customized portfolios for the world's most sophisticated investors using a highly disciplined, research-focused approach that prudently integrates primaries, secondaries and co-investments.

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