Private Equity Education Series
Part 1: What is *Private Equity?*

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This primer is designed to assist investors in furthering their understanding of private equity fund investing. It explains the basics of private equity as an asset class, the pros and cons of making such investments, highlights popular sub-sectors and points out salient considerations in portfolio construction and performance measurement. It is intended to serve as a practitioner's quick guide to private equity fund investing.

Investing in a private equity fund is often labor intensive as the term “private” itself implies a space that is information starved. Newcomers to this space are at a disadvantage as the industry is relationship-based and some of the best funds are hard to identify and often tend to be oversubscribed. It is also difficult to create small, diversified portfolios as minimums to access funds are often greater than what individual high-net-worth investors are able, willing, or ought to commit. Moreover private equity itself is a very broad asset class, encompassing many sub-sectors such as venture capital, turnaround investing, special situations, various types of leveraged buyouts, mezzanine, international and emerging markets. This variety within private equity can itself be a source of confusion.

Yet, the benefits of adding private equity to an investment portfolio can be substantial. It is therefore worthwhile to develop a solid understanding of the merits of private equity investing as well as the issues and risks involved.

Private equity basics

Private equity funds pursue a business model that is based on acquiring control of companies to increase the market value of their pooled capital through active engagement and then exiting at a later stage at a profit. This engagement may include demands for changes in management, the composition of the board, dividend policies, company strategy, company capital structure and acquisition/disposal plans. Private equity funds sometimes also take public companies private for a period of restructuring before either returning it to public ownership or by selling it to another company or fund.

Property and infrastructure funds are often included within the definition. Generally, these funds are set up to buy infrastructure or property-based companies that deliver both capital gains and long-term predictable cash flows.

UBS Financial Services Inc. (UBS FS) is pleased to provide you with information about alternative investments. There are a few points we would like to raise with you at the outset.

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Private equity offers the opportunity to share in the development of companies that have the potential to achieve above-average growth. Managers of private equity investments work in partnership with the firms they invest in to create value by growing revenues and profits as well as optimizing the capital structure. Ultimately, it is largely the collaboration between firm management and private equity managers that determine a company's destiny, and not the vagaries of the stock market.

Given the specific characteristics of the private equity market, fund manager skills have a more significant impact on fund returns than is the case for funds investing in public securities markets. In public markets, a great deal of company information is freely or at least easily available and is therefore by and large incorporated in asset prices. In contrast, in private equity, information is largely private. Fund managers must therefore have a much more hands-on approach to selecting companies and interacting with their management. This greater effort, however, allows fund managers to capture economic rents that would not be available in an investment space with readily available public information. Another related feature, the long-term nature of private equity investments, allows investors enough time to implement and effect fundamental and lasting changes. In addition to this, private equity arrangements include compensation structures that strongly incentivize company executives as well as private equity managers to achieve attractive returns for their investors. Private equity funded firms tend to exhibit corporate governance that better align the interests of investors and management. These are features that can help drive value creation and performance.

Private equity is sometimes perceived to be a higher-risk, high-return asset class. The perception of higher risk stems from its traditional close association with venture capital - the making of equity investments in young companies with strong potential for growth, often provided pre-revenue and usually pre-profit- which is a riskier sub-sector of the asset class. However, investing in a risky start-up company is but one small segment of the private equity market. By far, the largest part of the private equity sector involves buyouts of established companies with solid customer bases, proven products and quality management. Other sub-sectors include control oriented distressed investing, providing mezzanine financing, supplying growth capital and implementing variants of special situation opportunistic investing.

Generally, **private equity funds** have the following **characteristics:**

- an intended limited life of 10-12 years;
- no continuous capital raising during the life of the fund, as investments are made from calling on capital already committed by their investors;
- illiquid investments and no requirement to redeem investors' interests upon their requests;
- no routine acquisition of listed securities or derivatives as the focus of their investment strategy.

To summarize, the investment strategy of private equity funds is characterized by the deployment of equity capital targeting investments for financial returns arising out of long-term capital appreciation. Many of their investee companies are unlisted firms, a sector that generally has limited access to bank and capital market financing. The private equity industry also provides an important source of growth capital for small companies for business expansion (including capital expenditure, working capital and strategic acquisition), management buyout and re-capitalization. Exits from investments are through a listing of the shares of the investee company or strategic sale and, to a lesser extent, through structured sale such as the buyback of the fund's equity interest by the investee company or its other shareholders. In addition, during the investment holding period, private equity fund managers add value to investee companies through instilling corporate governance, providing advice on financial, strategic and operational matters, as well as strengthening management teams.

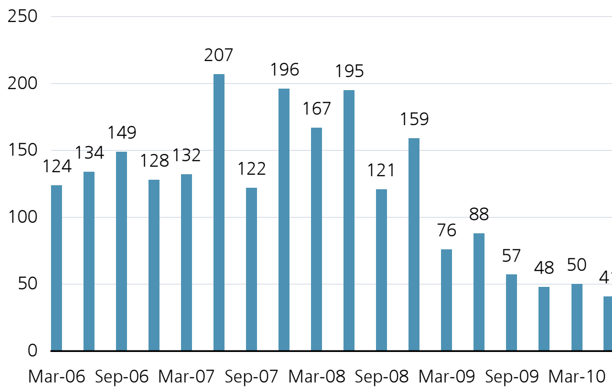
How large is private equity as an asset class?

Private equity is still a small asset class compared to listed equities and fixed income markets. In the wake of the financial crisis, the amount of fundraising by private equity funds declined substantially (see Figure 1). Nonetheless, globally around $2.5 trillion of capital has been raised and cumulatively deployed through fund investments. In addition, we estimate that at the end of 2010 around $400 billion of committed, but uncalled, capital will remain. While these amounts may appear substantial, they pale in comparison with the global market capitalization of listed stocks, which stood at $50 trillion as of September 2010.

What are the typical requirements to invest in private equity?

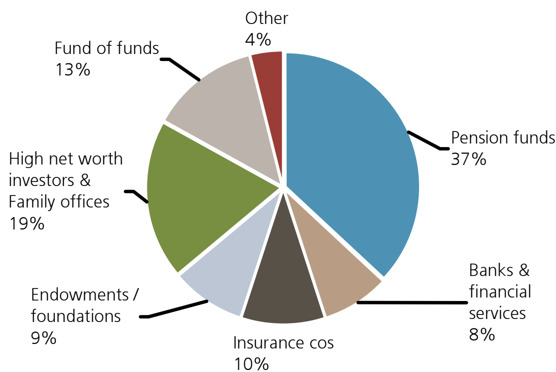
High net worth and Family offices have been traditional participants in this space and remain a key part of the investor community.

Figure 1: Private equity global fundraising
Capital raised by quarter (01/01/2006 – 06/30/2010, in billions of dollars)



Source: Pregin (2010)

Figure 2: Private investors account for nearly a fifth of the private equity market
Private equity investor base as of 2009



Source: BCG, Hennessey, Preqin, 2009

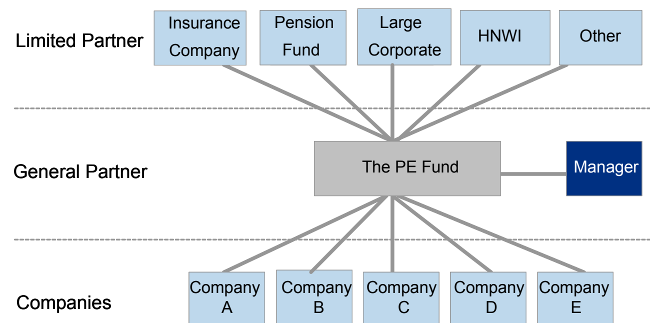
The minimum commitments that private equity firms set for their funds generally run from $5 million to $20 million. Fund of fund managers (described later in the series) generally set minimum commitments in the $250,000 to $500,000 range for individuals, and at significantly higher levels for institutions. At their discretion, General Partners can make exceptions to these minimum commitments, and they often do. Amendments made in 1996 to The Investment Company Act of 1940 in the United States give private equity firms an incentive to accept individual investors if they have investable assets of $5 million or more, and institutional investors if they have investable assets of $25 million. The incentive is that private equity firms can accept up to 499 so-called "qualified investors" as Limited Partners in their partnerships; otherwise, they can accept a maximum of 99 Limited Partners.

Under Regulation D of the Securities and Exchange Commission's rules, which governs the private placement of funds, private equity firms under most circumstances cannot have more than 35 unaccredited investors as Limited Partners. To be accredited, an individual investor must have a net worth of $1 million (or joint net worth with spouse), or have made at least $200,000 in each of the prior two years (or joint income with spouse of at least $300,000), and have a reasonable expectation of making at least the same amount next year.

How do private equity funds work?

Structure – Private equity funds typically are structured as private Limited Partnerships. The individual managers of a fund make up the General Partner. The named General Partner entity in the partnership tends to be a limited liability corporation. The General Partners of the partnership are responsible for the day to day management of the partnership's investment, as well as general liability for any lawsuit that may be brought against the fund. Partnerships are preferred investment structures because of their ability to accommodate both pension and non-pension investors, favorable tax treatment, well-established legal precedent and familiarity. The Limited Partners of the partnership are the investors, i.e., the main providers of capital. These are typically wealthy individuals, endowments, pension funds, and other institutional investors. They must not be actively involved in the day-to-day operations of the funds if they are to maintain limited liability status (see Figure 3).

Figure 3: Structure of a private equity fund



Source: UBS

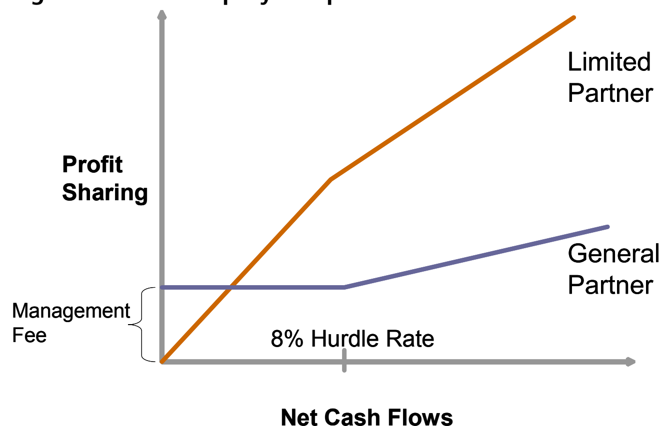
An important element of limited partnerships is that the General Partners also commit investment capital to the fund. This ensures that mutual interests are well aligned. Private equity partnership agreements signed by the parties involved govern the actions, and carve out the roles, of both the General and Limited Partners. Agreements typically provide for an investment period of five to seven years, and for a partnership term of 10 to 12 years.

Capital drawdown and distribution – General Partners of a fund draw down capital from the Limited Partners as and when they make investments. General Partners call down capital only as they require it, rather than in pre-set amounts according to a rigid timetable. If an investor fails to fund a capital call from a fund when due, the fund may exercise various remedies with respect to such investors to forfeit, or sell, all or a portion, of its interest in the fund or requiring that the investor immediately pay up the full amount of their remaining capital commitment. Cash or stock is returned to Limited Partners after the General Partner has exited from an investment. Stock distributions are sometimes referred to as "in-kind" distributions. The partnership agreement governs the timing of distributions to the Limited Partner.

Fees, profit sharing and incentive alignment between general and limited partners – While fees and profit sharing (carried interest) may occasionally vary across partnerships, the "2-and-20" structure is the most prevalent. "2-and-20" means that the annual management fee is 2% of the committed capital, and when final investment gains are realized, 20% of the profits go to the General Partner as their profit share. The fee structure for private equity funds – sources of income for the General Partner – comprises a variety of different component parts, including, but not always limited to all of the following:

- **Management fee –** These payments are typically set at approximately 1% - 2% of committed capital during the initial investment period (of about five years). These payments then usually fall back to a lower percentage of the total of un-drawn capital plus the acquisition cost of investments still held (i.e., excluding capital already returned to investors). The fees are usually payable from the outset of the fund's life. To avoid individual funds being churned to increase management fees, the fee may be reduced further or removed if a younger concurrent fund is set up.
- **Transaction fees –** These can amount to 0.5% to 1% of deal enterprise value. These fees represent a success fee for identifying and completing a transaction. Such fees are usually credited to the fund or split with the fund and the General Partner on a prearranged basis. Abort fees (i.e., fees to recover expenses involved in deals which are eventually not consummated) traditionally have been charged to the fund. However, this can be a point of negotiation between the Limited and General Partners, with Limited Partners increasingly seeking to have abort costs netted against transaction fees.
- **Monitoring fees –** These may be charged for continuing to ensure that the transformation process of a company acquired by the fund is going according to plan. These tend to be relatively small and are increasingly uncommon.
- **Carried interest –** This is a performance fee sharing arrangement and usually equates to 20% of capital gains. This is typically not paid out until Limited Partners' capital has been returned and a specified rate of return on their investment has been achieved. This is designed to incentivize the fund manager but delays the moment at which a fund becomes profitable from the fund manager's perspective.

Figure 4: Private equity compensation illustration



Source: UBS

Carried interest calculation

Calculation of carried interest varies, and it is important to understand how this is arrived at. The industry has evolved from a deal-by-deal calculation of carried interest to the aggregation method. Previously, the carried interest was based on individual portfolio deals where deal-by-deal carried interest allowed General Partners to receive carried interest from profitable deals without being penalized for unprofitable deals. As such, deal-by-deal carried interest created a temptation for General Partners to concentrate on strong performing companies while neglecting mediocre performers. To align the interest of the Limited and General Partners, deal-by-deal accounting has been virtually eliminated.

- **Hurdle –** Most contracts today include a provision referred to as the "hurdle", or "preferred rate", which requires that the investments achieve a minimum rate of return before the General Partnership receives its carried interest. This implies that a return beyond the Limited Partners' capital contribution must be achieved before the General Partner can share in the profitability of the investment. The hurdle rate is intended to align the interests of the General and Limited Partners by giving the General Partner added incentive to outperform a traditional investment benchmark. Hurdle rates typically range from 5% to 10%.
- **Clawback –** These are "look back" provisions which allow for a review of the total profit distribution from the partnership at the end of the term. The purpose of a clawback is to provide assurance that Limited Partners have received their capital contribution, the fees they have paid, and a prespecified hurdle rate of return before any carried interest is shared. Additionally, the clawback is a mechanism to recapture overpayments to the General Partners if they received more than their stated carried interest.

Conclusion and outlook

In summary, private equity is an illiquid long-term asset class, which, when approached with the necessary expertise, has the potential to improve the risk / return characteristics of an investment portfolio. Properly included, private equity complements listed equity portfolios and has the potential to provide a different source of return, enhance diversification and lower volatility. Private equity is heterogeneous and includes several sub-sectors, all of which have their own unique characteristics. Given large dispersion of returns across private equity managers and a degree of performance persistence, manager selection is of critical importance. The following installments in this series of reports will expand on the benefits and risks of investing in private equity, highlight the salient differences between the various existing sub-sectors of the private equity world, and address a number of important portfolio construction and performance measurement issues that investors need to be aware of.

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