ARGENTUM CENTRE *for* PRIVATE EQUITY

Private Equity – An Introduction

Private Equity?

- What is Private Equity and why should we care about it?
- By definition, we are considering *equity* investments in private or closely held firms.
- Typically either start-ups (VC) or mature firms (LBO).
- PE works as an alternative source of capital for firms.

How can one invest into PE?

- There are three ways
  - Direct investment
  - Investment into a PE fund
  - Investment into a PE fund-of-fund
- Trade-off between increasing fees and increasing diversification

How are PE funds structured?

- Normally PE firms raised closed-end, finite maturity funds
  - Funds last for ten years, can be extended though.
  - Investors pledge money, funds are drawn down once investments are made.
  - Funds are usually invested during the first five years of a fund.
  - Any return from an investment is paid back to investors
  - 2-20 rule for fees and returns
- After ten years any remaining funds are returned to investors.
- A PE firm will typically attempt to raise a follow-up fund after all funds of the previous fund have been invested
- Limited fund life serves as a performance evaluation tool.

Fees

- How are PE Fund managers compensated?
  - There's a two-tiered compensation structure
  - 1.5%-2.5% annual management fee
  - 20%-30% Carry (success component)
- Incentives are aligned by several mechanisms
  - Carry is not received before all fees and a hurdle return have been paid out to investors
  - Fund managers typically own a fraction of their own funds

Most important

- Why should an LP invest into PE? What are the potential benefits?
- What should a minimum requirement be? What would be desirable?
  - (Risk adjusted) returns should compensate for risk and fees
  - We'd like to get additional diversification for our portfolio
  - We'd like the investments to be "politically correct"

Returns

- There's an intense discussion about the absolute magnitude of PE returns
  - Consensus that net-of-fee VC returns outperformed public markets in the 90's and underperformed afterwards
  - Buyout returns the results are more varied
    - Initial research showed net-of-fee underperformance relative to S&P 500
    - Newer papers however attribute this result to the data-source and claim that returns are higher than the S&P 500.
- There is also a discussion on whether there is persistence in returns
  - Possibly for VC funds, probably not for Buyout funds
  - Negative relation between size and persistence has been documented

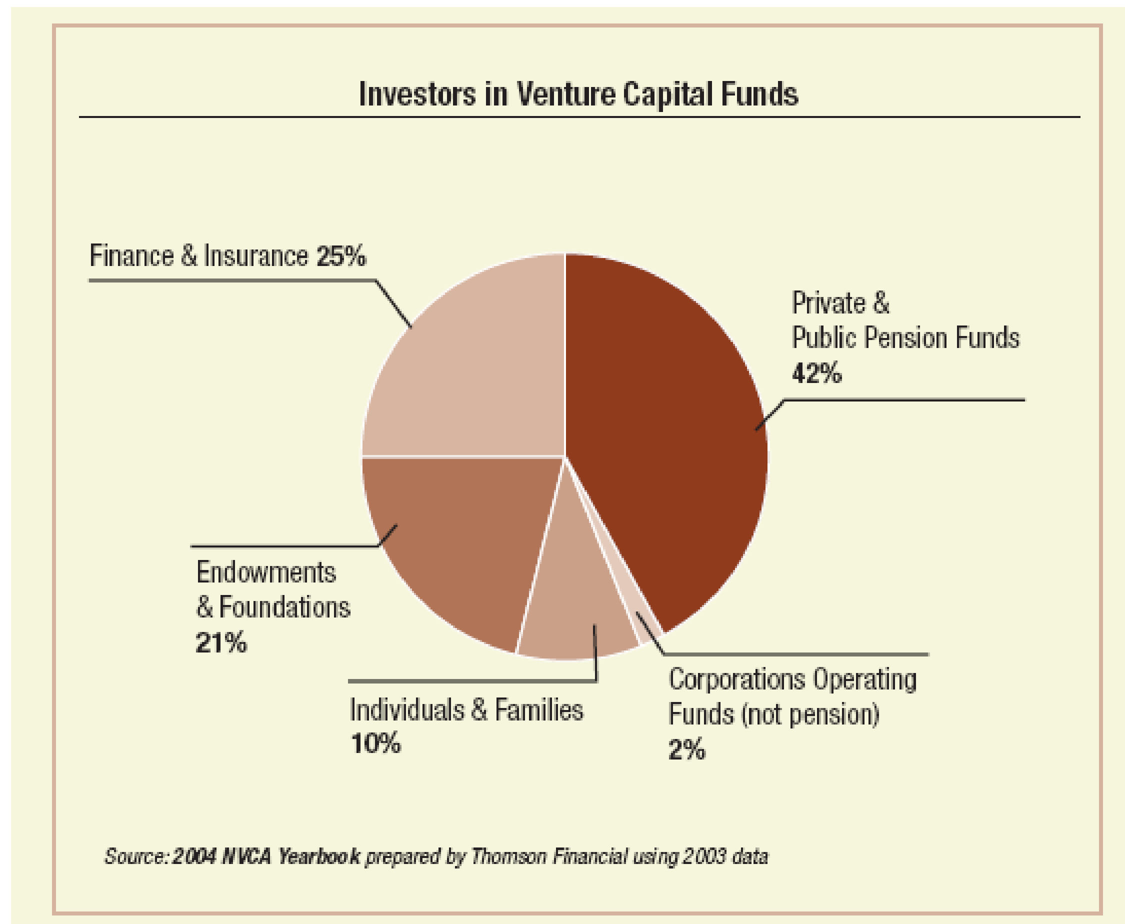
Return measurement

- Returns tend to be measured either in multiples or IRR's.
  - Mostly a data-problem. Difficult to get cash-flow data
  - Also, one seldom gets accurate valuations. Data is stale.
- Both measures are problematic
  - Difficult to control for investment duration
  - IRR can be "gamed"
  - More importantly they do not allow to control for risk
- Also, often investors do not seem to understand the difference between *absolute* and *risk-adjusted returns*.

Open Questions

- The research field has still many unanswered questions:
  - What net-of-fee returns can we achieve in PE? Or to put it differently: is PE worth it for it's investors?
  - How can we quantify risk in PE?
  - Does PE, in particular LBOs, improve firms in the long run?
  - How can we build a successful VC market? How much state support do we really need?

Who invests?



How do PE deals work?

- Venture Capital and Leveraged Buy-Out Deals work in a similar but not identical fashion.
  - A VC deal is characterized by an initial equity investment of 20-40% and subsequent financing rounds.
    - The VC receives extensive control rights
  - In a LBO deal the buyer acquires the whole firm and finances the deal with a mixture of debt and equity.
    - The debt is raised from external sources (i.e. banks)
    - The firm's managers receive a large stake (often around 10%)
- After 3-5 years the investor sells his stake to another firm/investor or via an Initial Public Offering (IPO).

Would you invest into this product?

- CPU: 8bit MOS Technology 6502 – 1MHz
- 4 KB of RAM,
- an audio cassette interface for loading programs and storing data,
- Integer BASIC programming language built into the ROMs
- Screen: 40 columns by 24 lines of monochrome, upper-case-only, 560x192 Resolution
- It even has apps!

SEQUOIA

People Build Companies

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Aruba	Aspect Development	Assurex Health	Aster Data
Atari	Avanex	Barefoot Networks	Barracuda Networks
Birst	Bit9	Blue Danube Systems	Cafepress
Carbon3D	CenterRun Software	Chartboost	Cisco
Clari	Clearwell Systems	Clever	Click Security
Clickatell	Clutter	Cohesity	Comprehend
Cumulus Networks	Cypress	Decolar	Docker

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Example LBO Balance Sheet before

Asset Value	1,250	1250	Equity
	1,250	1,250	

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Example LBO Sheet after

Asset Value	1,250	550	Bank Debt
Goodwill	200	300	Senior
		250	Junior
		700	Bonds
		400	Senior
		300	Subordinated
		1250	Total Debt
		200	Equity
	1,450	1,450	

Private Equity - Implications

- Public Equity can be easily sold via the stock exchange

- PE investments are illiquid.
  - One strand of theory belives this leads to more monitoring
  - It may lead to less pressure from stock markets:

Dell in $24 Billion Deal to Go Private

By MICHAEL J. DE LA MERCED and QUENTIN HARDY

9:22 p.m. | Updated

For Dell, a $24.4 billion deal to take itself private is a bold move out of Wall Street's harsh spotlight as it tries to remake itself in a world where personal computers are no longer the big business in technology.

Source: NYT, 5.2.2013

Private Equity - Implications

- VS Banks: what are the implications of such an investment?
  - Shareholders have rights that differ from creditors
    - Dividends instead of interest payments
    - Voting rights
  - Different rights require different governance structures
    - PE Investors often require board seats and/or other contractual arrangements that separate ownership from control

Incentive Effects

- There’s a second effect at work here
- An equity stake is not fixed in its size – its value can change
  - Gives PE investors the incentive to increase the net worth of their investment
- Dividends depend upon the firm’s profits – and the voting rights in the firm’s boards and shareholder meetings.

Implications for Firms/Owners

- Obviously these are strong differences to bank loans
- Why should owners accept such terms?
- “Maximize the total pie instead of minimising the part that you give away”
  - Ideal for firms with negative initial cash-flows, such as start-ups. Additionally these firms have often inexperience managers.
  - Also ideal for firms in need of restructuring. New owners will “re-engineer the firm”
    - Typically both the firm’s operations and governance structure will be evaluated.