HEALTH WEALTH CAREER

# UNDERSTANDING PRIVATE EQUITY

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## INTRODUCTION

Private equity has the highest expected returns of both traditional and alternative investments, and can play a key role in achieving higher total portfolio returns. The drivers that make the returns so compelling are a combination of strategic and operational improvement, innovation, process-driven factors, leverage, and public equity market returns. Capturing these returns requires some significant investments in resources, governance, and relationships (or the willingness to pay for someone else's ability to implement a portfolio), as well as patience and a tolerance for illiquidity. Private equity investing has some of the highest implementation risks of any asset class — this area offers some exceptional potential rewards for sophisticated investors, but it is not necessarily suitable for all investors.

In this paper, we will review some basic asset class characteristics, return expectations, return drivers, evidence of outperformance, and implementation considerations, and discuss the optimal use of private equity in a portfolio. Because private equity investing involves some concepts not found in other asset classes, we have provided a glossary of terms at the end of this paper.

## PRIVATE EQUITY

Private equity can be defined as a non-tradable investment in equity or equity-like securities. Although we primarily associate private equity with private corporate investments, it also covers investments in certain hard asset sectors.

Private equity investing differs from public equity investing in some significant ways: liquidity, pricing, control, governance, value adding, alignment of interests, and performance measurement. The most obvious difference is liquidity. Stocks are generally able to be sold at their most recent carrying value. Private equity funds do not generally contain redemption provisions, and the funds generally have a primary term (or life) of 10 years. Investors' capital is returned upon the realisation of an investment, which is at the manager's discretion. Investors can sell a partnership interest in the secondary market, but there is typically a meaningful cost to doing so and such transactions can take months to complete.

Stocks are also priced daily in the markets, whereas a private equity fund is generally valued no more than quarterly using various inputs and assumptions. At least once a year, an external party (usually an auditor and potentially a valuation firm) reviews and opines on the portfolio valuations. In accounting terminology, private equity assets are Level 3 assets that are illiquid, and the values are reported months in arrears.

One other element of private equity investing that differs from public equity is control over the investment. A private equity fund manager has a much higher degree of control over a portfolio company than does a public equity investor. Private equity managers tend to control the board of directors of a company either alone or in concert with other investors. Management is subject to change at the fund managers' will. By comparison, the level of influence of public equity investors seems rather inconsequential. Rather than effect change, the practical option for an unhappy public equity investor is to just sell.

A private equity fund manager has a much higher degree of control over a portfolio company than does a public equity investor.

**An even more significant difference is the ability of a private equity fund manager to add value. A manager has the ability to:**

> Acquire assets away from an auction process.
> Impact the strategic direction of a company.
> Improve the operations of a company.
> Drive the highest price at exit.

It is these activities that generate the excess return investors seek in this asset class.

Private equity investors have a greater alignment of interests with the fund managers, primarily due to the level of capital being invested by the fund manager (GP commitment) and the fact that the fund managers' participation in profits is a powerful performance incentive. Similar alignment is rarely achieved in public equity investing.

Private equity investors have a greater alignment of interests with the fund managers.

Lastly, private equity investment performance is measured by internal rate of return (IRR) rather than time-weighted return (TWR). The drawdown at investment and distribution upon sale means that the value of a private equity investment changes dramatically over its life. A dollar-weighted return measure is more appropriate than time-weighted return since it captures the gain relative to the amount invested. This makes benchmarking more complicated and investor reporting more obtuse. It is harder for investors to determine whether they have been successful in terms of their strategic allocation as well as the quality of their fund and strategy selection.

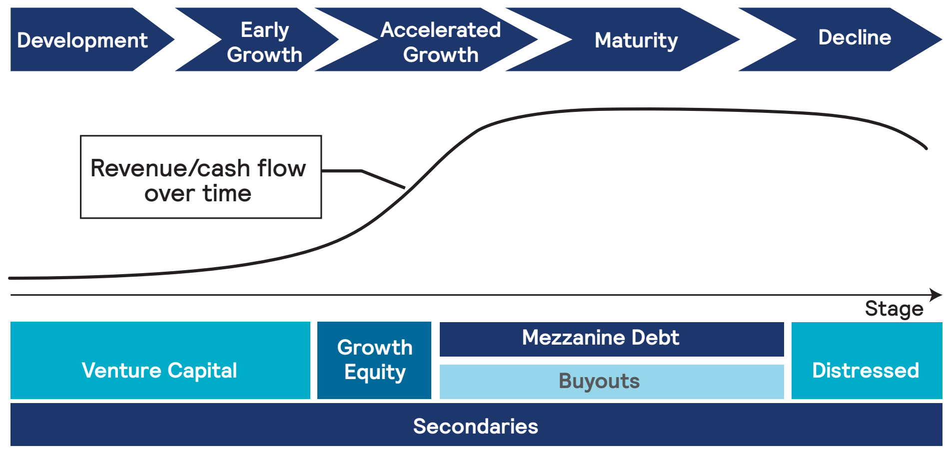
## PRIVATE EQUITY STRATEGIES

Private equity can refer to any private investment, but within institutional investing we think of private equity as encompassing buyouts, growth equity, venture capital, and special situations. The special situations category is the catch-all for credit, distressed debt, turnaround, and asset-based funds. Although there are private equity funds that invest in real estate, infrastructure, and natural resources, we group those strategies into real assets.

**Viewing the life cycle of a company in terms of its cash-flow-generative abilities, there is a continuum of strategies that can be ordered as follows:**

> Venture capital begins with early stage, pre-revenue companies and extends through late stage when a company develops a product and begins generating revenue.
> Growth equity is the next phase, when the risk shifts from whether a product will work to whether it can gain market adoption. Such companies might not be cash-flow positive at the point of investment but would be expected to be so at the point of realisation.
> Buyouts of cash-flow-generating companies are grown from small market to middle market to mega buyouts. Larger companies are typically considered safer and more stable, with broader diversified cash flows, but this is reflected in higher valuations. Buyouts may be financed with mezzanine debt. Mezzanine funds also tend to have equity co-investments.
> Distressed and turnaround strategies usually involve companies that have gone into decline.
> All of the investments along the continuum are typically held in limited partnerships that are subject to sale by one investor to another in the secondary market.

**FIGURE 1** Private Equity Landscape in the Business Cycle Framework




### Buyouts

Buyouts make up the largest strategy group in terms of the amount of capital and number of firms. The essence of a buyout is that the investor gains control of the company. The equity owners typically engage with management and provide incentives for good performance. The level of interaction between the buyout fund and the company varies from daily hands-on involvement to fairly passive observation from a distance. Industry focus varies from firms that are generalists to ones narrowly focused on a single industry. The size of transactions also can range from very small deals of under $25 million to multibillion-dollar acquisitions of public companies. Determining what part of the market is most attractive is often a matter of preference driven by what characteristics an investor values.

The largest buyout funds are institutional vehicles managed by experienced firms. Raising a $10 billion fund takes a track record of success. The fees are also usually the lowest at this end of the market. However, the largest funds have not necessarily been the best performers. Small funds are often able to find undermanaged companies and buy at the lowest valuations. The alignment of interests also tends to be high, but such companies are more fragile and small managers are often not as ready to manage institutional capital. The middle market has become a popular place to focus due to the ease of finding institutional firms with good track records that are not yet “too big”.

### Venture Capital

The next largest sector of private equity is venture capital. This area consists of investments in new products and services where the lure is the outsized returns from investing in the next must-have technology or breakthrough drug discovery. There are also a lot of venture-backed companies that fail; investors can lower their risk profile by targeting investments in more mature companies that might already have revenue and be closer to being sold. Whatever the approach, this space has the highest dispersion of returns. The most successful investments dwarf the returns available in other strategies, but there is a meaningful risk of a disappointing result in a long-duration investment.

Venture capital funds tend to be smaller. Most early stage funds are under $300 million of committed capital. Even the largest venture capital funds are "only" $2.5 billion. These funds tend to have far fewer partners than other strategies, and firms with only two or three partners are not uncommon. The fees as a percentage of capital are the highest — high fees and the perceived risk of loss tend to be the factors that turn off many investors.

### Growth Equity

Growth equity investments fall in between the venture capital and buyouts sectors. These investments tend to be minority investments like venture capital and may be made in companies that are not cash-flow positive but are typically providing capital to enable a company to grow faster. Unlike venture capital, these investments are not typically syndicated among multiple firms and the growth investor is usually the first institutional investor in a company. Venture-capital-backed companies may also have growth equity stage financings late in their development, but growth equity specialists are not often involved. Such financings do not tend to offer much control or significant equity ownership to the new investors.

### Special Situations

The special situations sector covers just about everything else that is private, including distressed strategies (financial or operational distress), certain credit-related strategies, and asset-backed investments. Distressed investments are counter-cyclical to buyouts: an expanding credit bubble enables an expansion of buyout valuations; a recession tends to cause a drop in borrower cash flow, and this leads to defaults on the mountain of debt. Distressed funds are positioned to buy debt, take the borrowers through a capital restructuring, and benefit from the eventual economic recovery. Asset-backed strategies acquire hard assets such as planes or ships when they are cyclically inexpensive and hold them through a price recovery. These strategies are highly attractive during certain periods of the economic cycle.

## THE MECHANICS OF PRIVATE EQUITY INVESTING

### Building a Portfolio

A private equity portfolio is normally built through making commitments to a diversified array of funds over time to have a portfolio that is diversified across strategy, manager, geography, sector, and time. A commitment to a private equity fund is a legally binding commitment to fund the investment as requested by the manager. The term of a typical fund is 10 years plus additional time to complete the liquidation of the portfolio, if needed. Any likely changes in the status of an investor's portfolio must be considered before entering into such long-term agreements.

> The implementation and management of a private equity portfolio allocation is a constant process of adding to the portfolio to maintain the exposure.

For most investors, the implementation and management of a private equity portfolio allocation is a constant process of adding to the portfolio to maintain the exposure. The resources required to do this can be substantial and tend to be a key consideration in determining the best route for implementation. Some large plan sponsors manage their portfolios in-house, whereas most others opt to outsource implementation to third parties.

### Vintage Year

Unlike most asset classes, the element of timing certainly has an impact on private equity outcomes. That is why diversification across vintage year — the year of inception of a partnership — is an important element of private equity investing. Macroeconomic conditions, asset pricing, capital market issues, and other trends can influence the success of a strategy initiated at a specific point in time. Diversification across time and tilting a portfolio to benefit from favourable trends or avoid unfavourable ones in a given vintage year can improve the odds of success.

One important element of vintage year diversification is the disciplined, steady deployment of capital.

One important element of vintage year diversification is the disciplined, steady deployment of capital. Investors cannot time the market in private equity any better than in traditional investments. To build and maintain an allocation is also difficult with episodic participation. The most successful investors take a very consistent approach, and this is considered best practice in the private equity space.

### Cash-flow Management

The ongoing management of a diversified private equity portfolio involves the provision of capital to fund new investments and the receipt of returns of capital upon the sale or realisation of a portfolio asset. Capital calls are due upon five- to 10-day notice. These capital calls will occur irregularly over the three- to five-year investment period of a fund; thereafter, capital calls will be issued mainly for follow-on investments, fees, and expenses. Such capital needs to be held in relatively liquid securities to keep frictional costs to a minimum. The oversight of such cash flows is one element of ongoing portfolio maintenance that needs to be considered in the management of private equity portfolios.

### Fees

Private equity has higher fees than almost any other asset class. A typical fund will charge management fees on committed capital during the investment period. The fees on invested capital are a multiple of the headline fee since portfolios are built over three to five years. After the investment period, a fund tends to levy fees on remaining invested capital rather than net asset value. During this period, the management fees as a percentage of net asset value are more reasonable. Investors tend to see a significant increase of value upon sale and that value is never subject to the management fee. On a blended basis, the management fees are still high, though more in line with paying management fees on net asset value.

### The J-curve

In the early years of a fund, investors pay fees and the gross returns from a portfolio are typically flat or not positive enough to overcome the fee burden. As a result, the net returns are usually negative during the earliest portion of a fund's life. In addition, certain strategies are prone to taking writedowns early or will see valuations take a hit from the need to reduce cash flow to make improvements in businesses. This adds to the negative returns before the winners are recognised and net returns turn positive. Mapping the IRR over time produces a curve that is shaped like the letter J.

The "J-curve" is important to understand because it can have a negative impact on investor psychology, and can be managed. Investors add private equity into their portfolios in pursuit of higher long-term returns. The J-curve is explained to investors at the outset, and investment committees understand such concepts, but it is more difficult to deal with in reality than in theory. Having a portion of your portfolio — which is designed to add value over public equities — show negative returns for a few years is difficult to accept. In practice, a lot of time is devoted to explaining early years of underperformance of individual investments and the impact of the private equity portfolio on the overall portfolio.

The most effective way to combat the J-curve is to tap the secondary market for more mature exposure to private equity assets. This can be done via secondary funds or through the direct acquisition of mature assets on the secondary market. A healthy allocation to such assets in the early years of a program can offset the impact of new investments and bolster investor confidence in the asset class.

Return expectations tend to be in the range of 3%–5% over large cap equities.

## RETURN EXPECTATIONS

Private equity is an illiquid asset class. The investments are typically structured as limited partnerships and the investment manager determines the timing of the contributions and distributions of capital. Such funds do not offer redemption provisions. Alternative investment products with redemption provisions are classified as hedge funds. A secondary market exists for such investments, but the selling costs may be uncomfortably high. As such, investors require a higher return from private equity relative to public equity. The typical return requirement is 3%–5% per annum over a listed equity benchmark across a full investment cycle.

Another way for investors to develop some market return expectation for private equity is through building up the returns from cash and adding return premiums for equity risk, small cap risk, and a liquidity premium. Whichever way investors go about determining their expectations, the results tend to be in the range of 3%–5% over large cap equities. Capturing this return premium is based largely on an investor's ability to implement a portfolio, as there is no passive option for participating in private equity.

## RETURN DRIVERS

The ability to generate positive returns in a buyout investment is pretty straightforward. There are a limited number of factors that will impact the enterprise value of a company: revenue, costs, cash flow, growth, and cash-flow multiple. There are some other factors of course, like the value of a brand or intellectual capital, but for the sake of simplicity, we will focus on the major factors.

Enterprise value (EV) can be described as cash flow or EBITDA times a cash-flow multiple (CFM) or:

$$EV = EBITDA \times CFM$$

The enterprise value less net debt (D) equals equity value (E):

$$E = EV - D$$

To generate returns, an investor needs to grow enterprise value or reduce debt. An investor can grow enterprise value by increasing EBITDA or the cash-flow multiple.

Cash-flow multiples tend to be influenced by the public equity market comparables, company growth rate, and company size. One point of comparison for a private company is the valuation of similar publicly traded companies. Private companies usually trade at a discount to public companies due to their illiquidity, but the valuation changes tend to be directionally consistent.

Faster growing companies command higher valuations and higher multiples. Therefore, one of the goals of a private equity manager can be to accelerate revenue growth by growing the product line-up, executing geographic expansion, raising prices, or getting rid of slower-growing non-core businesses.

Larger companies tend to be more attractive as acquisition candidates as well as less risky, and therefore are valued using lower discount rates and higher multiples of earnings or cash flow. Getting bigger can be accomplished through organic growth, but is often accomplished by acquiring other companies. The strategy of buying a platform business and building it through acquisitions of smaller companies is called “buy and build”.

### Growing Cash-flow

Cash-flow growth is an important driver of private equity performance. Strategic and operating initiatives are at the core of how a private equity firm adds value. Strategic initiatives can vary from entering or exiting a line of business, acquiring a competitor, or launching an international strategy. We think of board-level decisions as primarily strategic inputs.

Operating improvements are the types of changes that will drive margin expansion and organic revenue growth. Over the last decade, financial buyers have put a greater focus on adding personnel able to improve the operating performance of portfolio companies. Whereas once it was common to see a buyout firm staffed exclusively by investment bankers with the skills required to optimise a balance sheet, it is now common to see former operating executives playing key roles within buyout groups.

### Leverage

Investors cannot have a complete picture of a leveraged buyout without considering the impact of a leveraged capital structure on return and risk.

Investors cannot have a complete picture of a leveraged buyout without considering the impact of a leveraged capital structure on return as well as risk. Buying a company without the use of debt financing is not likely to be optimal unless the company cannot service interest payments. Over time, the typical level of debt in a buyout deal changes as lenders loosen or tighten credit standards. During periods of tight credit, a capital structure may have an equity component of ≥50%, whereas during periods of loose credit, that may fall as low as ≤30%. The lower the equity contribution is, the higher the potential gain, and the higher the risk of a loss if the debt cannot be serviced. Investors should aim to find a capital structure that balances the return on equity with the flexibility and safety of a lower debt load.

### Non-cash-flow Drivers

Venture capital and distressed investments are two private equity subsectors that have very different return drivers. Venture capital is generally pre-cash-flow and relies heavily on innovation to drive returns. Financial distressed investing could be seen as being post-cash-flow, when the resolution of a debt default is primarily process-related.

### Innovation

Venture capital derives much of its returns from innovation and the ability to translate this into revenue and enterprise value. Such investments are typically made in companies developing new goods and services. These companies may have few employees, no revenue, and an uncertain future; although considered high risk, the payoff for success is significant. Finding venture firms that can identify innovative entrepreneurs and technologies and then shape them into leading companies (or ones worthy of being acquired, or able to go public) is at the core of succeeding in this space.

### Process

Distressed debt investing can be seen as largely a process-driven form of investing. Although it takes investment acumen to find mispriced investments relative to their intrinsic value, there is more to success than that. The work-out of a distressed debt situation via the bankruptcy process is one big negotiation. Investors best able to influence the process in order to get paid as much as possible for their securities tend to be the top performers.

Distressed equity investors intend to take control of the equity of a company post-bankruptcy. To the previous skills, investors must add some additional abilities to help a company succeed after a near-death experience. Often such funds appear to be just deep-value buyouts. When done well, there may be market-leading returns to be had.

## EVIDENCE

Private equity in the US has continued to outperform public markets.

Analysis indicates that private equity in the US has continued to outperform public markets, and for realisations of private equity investments in the period from 2006 to 2012, the excess had been 5.4% per annum (according to Ernst & Young). Relative performance in other key regions (Europe and Asia) has also been strong. Of particular importance is the change in the relative influences of the key drivers of this outperformance.

Academic research is generally supportive of the ability of private equity to outperform the public markets. The original research on private equity in the 1990s, such as that published by Kaplan and Gompers, used data from some large private equity portfolios. The emergence of private equity performance reporting services, such as Burgiss and Preqin, has made higher-quality data available to academics. The result is better quality research.

Harris, Jenkinson, and Kaplan's 2013 paper[1] offers a recent look at broad private equity performance:

> *"We present evidence on the performance of nearly 1400 U.S. private equity (buyout and venture capital) funds using a new research-quality dataset from Burgiss, sourced from over 200 institutional investors. Using detailed cash-flow data, we compare buyout and venture capital returns to the returns produced by public markets. We find better buyout fund performance than has previously been documented. Average U.S. buyout fund performance has exceeded that of public markets for most vintages for a long period of time. The outperformance versus the S&P 500 averages 20% to 27% over the life of the fund and more than 3% per year. Average U.S. venture capital funds, on the other hand, outperformed public equities in the 1990s, but have underperformed public equities in the 2000s. Our conclusions are robust to various controls for risk."*

1 Harris R, Jenkinson T, Kaplan S. "Private Equity Performance: What Do We Know?" available at http://areas.kenan-flagler.unc.edu/finance/PERC/HJK%20Apr%202013.pdf, accessed 14 August 2015.

Higson and Stucke[2] make a strong empirical case for the outperformance of buyouts. The abstract of their research paper is below:

> *"We present conclusive evidence on the performance of private equity, using a high quality dataset of fund cash flows that covers about 85 percent of capital ever raised by U.S. buyout funds. For almost all vintage years since 1980, U.S. buyout funds have significantly outperformed the S&P 500. Liquidated funds from 1980 to 2000 have delivered excess returns of about 450 basis points per year. Adding partially liquidated funds up to 2005, excess returns rise to over 800 basis points. The cross-sectional variation is considerable with just over 60% of all funds doing better than the S&P, and excess returns being driven by top-decile rather than top-quartile funds. We document an extreme cyclicality in returns with much higher figures for funds set up in the first half of each of the past three decades, and correspondingly lower returns towards the end of each decade. However, we find a significant downward trend in absolute returns over all 29 vintage years. Our results are robust to measuring excess returns via money multiples instead of IRRs, and are essentially unchanged when pricing residual values at observed secondary market discounts."*

The research that is less supportive of private equity tends to focus on returns adjusted for risk and/or complexity and/or liquidity. We have included the abstract from the 2013 paper by Sorensen, Wang, and Yang[3] below:

> *"We investigate whether the performance of Private Equity (PE) investments is sufficient to compensate investors (LPs) for risk, long-term illiquidity, and management and incentive fees charged by the general partner (GP). We analyse the LP's portfolio-choice problem and find that management fees, carried interest and illiquidity are costly, and GPs must generate substantial alpha to compensate LPs for bearing these costs. Debt is cheap and reduces these costs, potentially explaining the high leverage of buyout transactions. Conventional interpretations of PE performance measures appear optimistic. On average LPs may just break even, net of management fees, carry, risk, and costs of illiquidity."*

The argument that there is an actual cost of illiquidity or risk is theoretical. When we measure after-fee returns, we find there is a return premium in private equity. We acknowledge the asset class is complex and illiquid, but our primary concern is meeting investors' nominal return goals. Earning this illiquidity return premium is one of the objectives of private equity programs for institutional investors.

Anecdotal evidence would indicate that over a full cycle, the median return will probably outperform the public markets, but by a small margin. However, we believe investors can select quality funds in sufficient number to generate returns that are consistent with a 3%–5% margin in excess of the S&P500 or MSCI ACWI.

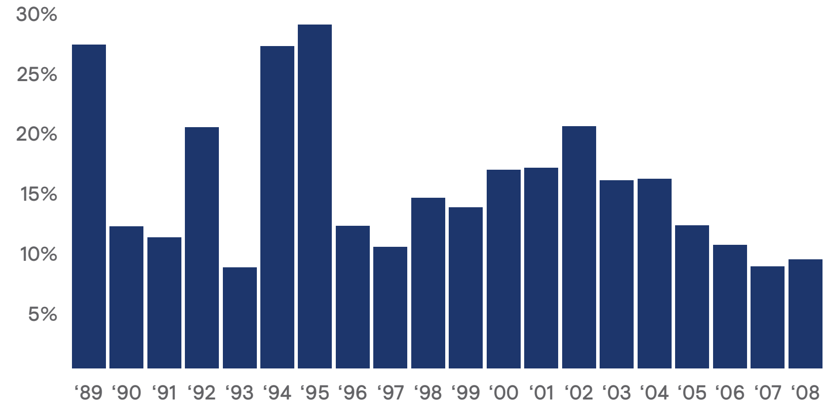
2 Higson C, Stucke R. "The Performance and Private Equity," London Business School: Coller Institute of Private Equity, 2012.

3 Sorenson M, Wang N, Yang J. "Valuing Private Equity," National Bureau of Economic Research working paper no. 19612, 2013.

## MANAGER SELECTION

Historically, the gap between returns across private equity managers has been significant (see Figure 2). The 20-year average spread between the IRR of the 25th and 75th percentiles for global buyouts is 15.4% through vintage year 2008. Manager selection and quality due diligence are essential elements in managing private equity portfolios. The potential difference in outcomes is larger than in any other asset class. In private equity, it is the difference between meeting one's return goals and falling short.

**FIGURE 2** 20-year Average Spread Between the IRR of the 25th and 75th Percentiles for Global Buyouts

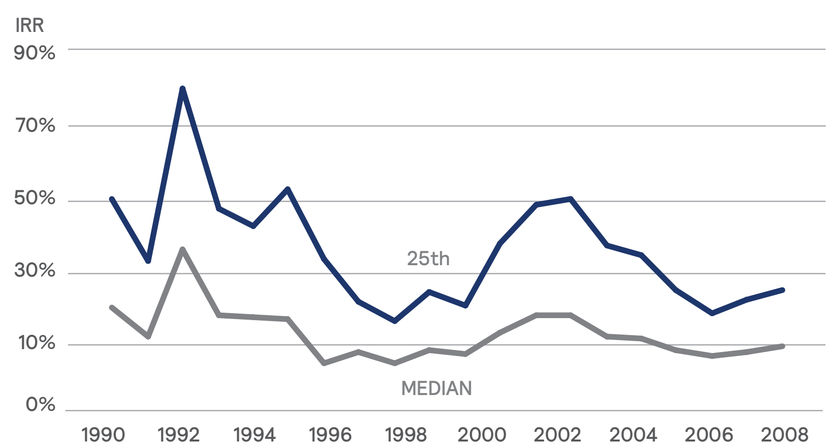



*Source: Private IQ, Global Buyouts, December 31, 2014*

Mercer believes our top, A-rated funds will outperform their peer group. We define private equity outperformance as performing in the top quartile of a given vintage year. Achieving this goal should lead to the outperformance of a portfolio versus public markets.

The value added potential of private equity manager selection is substantial. Figure 3 shows the spread between the median and 25th percentile US buyout fund from 1988–2008. Selecting funds in the top quartile offers a similarly large opportunity to add value. The median spread between the 25th percentile and top reported fund in the Thomson US Buyout universe from vintage year 1988–2008 is 27.4%. The median returns are not terribly impressive, but the potential impact of selecting better managers is extraordinary. Avoiding poor performers is also an important element of generating sufficient returns from this asset class.

**FIGURE 3** Premium Return for Top Quartile




*Source: Private IQ, Global Buyouts, December 31, 2014*

Looking forward, we see the performance distribution of private equity widening even further. We believe greater disparity in regional performance is likely in sector specialists versus generalists, and across fund size cadres. The differentiation among managers is now extending to the relationship between the fund sponsors and the portfolio company management teams. We see an increased recognition by prospective investee companies that a private equity relationship is less about capital and more about tapping the skill set of private equity managers. That is one factor that should favour operating-oriented firms and those with significant domain expertise in target sectors.

## VOLATILITY

We see the performance distribution of private equity widening even further.

Risk is most often defined as the volatility of an investment and the variability of returns over a market cycle. In this context, private equity could be seen as very safe or highly risky. Private equity returns are not volatile versus public markets, mainly due to the methodologies used to value private investments. In most cases, privately held companies are valued twice a year (June and December), new investments are often held at cost for 12 months after acquisition, and fund managers typically apply a discount to fair market value. From an accounting perspective, funds issue capital account statements quarterly, so there are only four valuation points per year.

During the worst year of public equity declines during the global financial crisis, 2008 private equity investments dropped far less in value (-23.6%) than the MSCI ACWI (-41.9%). Private assets also were slow to reflect the rebound in the prices of financial assets. In periods of weak public equity returns, private equity results have tended to outperform. In 2011 when the MSCI ACWI returned -6.9%, private equity returned 6.6%. However, in 2013, public equity returns were outstanding. The MSCI ACWI returned 22.8% and the Thomson Global All PE index return was 17.4%. This smoothing of returns means that the observed volatility of private equity will be lower than that of public equity. One could argue that this would justify assigning a lower risk premium to private equity. Asset allocation models usually assign a meaningfully higher volatility to private equity than public equity to keep the asset class risk return assumptions in line with more traditional assets.

Private equity returns are not volatile versus public markets due to the methodologies used to value private investments.

There is a good argument that the wide spread of returns from individual private equity partnerships and strategy groups would justify a much higher risk premium. A partnership will not behave in the same manner as a diversified portfolio. A portfolio has far lower volatility and tends to diversify away a lot of the risks of the underlying assets. Industry selection, leverage choices, customer concentration, small company risks, and other idiosyncratic risks play a big role in driving the outcomes in a private equity portfolio.

The inability to exit the asset class at any time at reported net asset values has been another reason higher risk metrics have been assigned to the asset class. This is a reasonable assumption, since the cost of liquidity can be high and is highest when market risk is at its peak. The increased efficiency of the secondary market may alter our view on this at some point, but liquidity will remain a consideration in our view of risk for the intermediate term.

In our opinion, an investor's view on an asset class should presume that the investor is managing a prudently diversified portfolio of assets so that many of the idiosyncratic risks are diversified away. Investors seem destined to assign higher volatility to private equity assets to maintain the risk-reward relationship with public equities.

### Correlations

The main risk factor in a private equity portfolio besides manager risk is equity market beta. Even with the smoothing mentioned above, most market observers assign betas to private equity of 0.8 to nearly 1.0. The slightly lower correlation to equity market indices is not a reason to invest in private equity.

## IMPLEMENTATION CONSIDERATIONS

### Liquidity

The lack of liquidity in a private equity partnership is a problem for many potential investors. A typical limited partnership will have an investment period of five years over which the capital will be contributed for new investments upon demand. Proceeds from realisations are returned to investors at the discretion of the general partner of the fund, subject to whatever guidelines are in the governing documents.

If an investor requires liquidity, the primary option is to sell a partnership on the secondary market. Such transactions may occur at net asset value for high-demand fund managers, but less-well-known managers or less-well-funded partnership interests will usually sell at a discount to carrying value. During the financial crisis, such sales might have required a 50% discount, but currently most quality assets will sell at minor discounts to fair value. The risk of needing liquidity from such investments makes them a poor fit for certain investors.

### Tolerance for Complexity

A low tolerance for complexity is another factor that tends to disqualify potential investors. Private equity investing is complex from both governance and operational standpoints. Keeping a portfolio invested requires regular investment decisions to commit new capital to partnerships to replace those investments that are being realised. This requires some meaningful organisational commitment to the process of investing in the asset class. Understanding one's governance bandwidth can help determine the appropriate implementation path or could lead to avoiding the asset class.

Another area of complexity is the operational overhead associated with managing the private portfolio. A single fund will generate a significant number of capital calls and distributions over its life. A typical fund will issue 2 to 4 capital calls a year for five years and may issue separate calls for management fees. Distributions tend to be more numerous than calls, as partial liquidity events for an investment are common. Valuations are provided 45 to 90 days after the end of a quarter and up to 120 days after year-end. Audits are made more complex due to the lack of market pricing for the assets. All of this combines to create one more obstacle to investing in private equity.

### Governance

Private equity investors must have sufficient internal governance resources to manage a portfolio. This may require staff to research potential investments and monitor existing ones. Pursuing investments will have a cost for travel and legal expenses. The use of funds of funds as a form of outsourced implementation is typically driven by such governance considerations.

Requiring a specialist adviser can have a meaningful cost as well. Besides capital costs, a time commitment is necessary. Investment committees need to allocate sufficient time for reviewing the investments or create an alternative approval processes. The flexibility to make decisions between formal board meetings is almost a must in order to deal with the unique portfolio management challenges posed by illiquid asset investing. Some investors do not have the governance bandwidth to implement investment programs that require so much time. The result has been growth in the number and variety of outsourced implementation options.

### Due Diligence

A thorough due diligence process is the most effective form of risk mitigation in this asset class. In certain asset classes, investors can rely heavily on quantitative analysis. Private equity partnership due diligence combines rigorous quantitative analysis with highly qualitative elements that rely heavily on the individual. The pattern recognition that comes with having reviewed a lot of similar investments is often cited as a key quality of an effective analyst. The analysis that separates the great opportunity from the merely good and that uncovers potentially fatal flaws in a well-crafted investment proposal is usually based upon the insights and judgment of the investment professionals involved.

### Access

One area in which new investors are at a disadvantage compared with long-time private equity investors is access to higher-quality fund managers. There are a substantial number of general partners that have been successful performers across multiple funds and are not seeking new investors. Existing investors in such funds are often willing to fill whatever capacity becomes available. The easiest solution to such a situation is to hire an adviser to assist in gaining access, or to outsource implementation to an adviser or fund of funds manager to gain access to high-performing managers. However, certain investors may find the cost of this intolerable. The alternative route is to seek out tomorrow's high-performing manager today, chip away at access to "closed" fund managers that an investor finds highly appealing, and be able to react quickly when opportunities arise to add such firms to a portfolio. Keeping the quality bar high for adding new managers is very important — dipping into the pool of third-tier managers and hoping for better results is generally a poor strategy.

### Persistence

Studies have shown that private equity fund managers exhibit a meaningful amount of performance persistence. The managers with funds that performed in the top quartile of their peer groups are more likely to have a subsequent fund that likewise performs in the top quartile compared with the fund managers whose prior funds were second, third, or fourth quartile. Investors try to improve their odds of investing in a fund with outstanding returns by focusing most of their efforts on managers that are demonstrating positive momentum. This is a key reason why certain managers are overwhelmed with demand for space in their funds while ones that seem comparable in many other ways can struggle to raise capital. For those investors without relationships with high-performing fund managers, such access can often be attained in some measure through an adviser. Accessing desired fund managers is a key factor in the value of an adviser and the role of delegated implementation in private equity.

### Environmental, Social, and Corporate Governance Considerations

Environmental, social, and corporate governance (ESG) factors are not usually a fundamental part of the traditional private equity investment process. However, governance is an area in which private equity strategies are most differentiated from other investment funds.

The nature of private equity investment is that funds typically have meaningful stakes in companies, meaning that they have influence and/or outright control over management and significant decision-making. Private equity funds are able to do this by concentrating ownership in one or a small handful of fund managers, unlike in listed companies. As such, private equity owners will often have influence over and/or control of the board of directors, and will seek to align management's interest with their own. This is a very active approach to governance. The view of a fund manager's integration of ESG considerations into its investment process is largely determined by how such control is used, rather than in its existence.

Individual private equity strategies span the full spectrum in terms of integrating ESG factors. Managers of private equity funds that lead in ESG integration tend to take significant responsibility for the private companies in which they invest through strong policies on, and clear evidence of, active and sustainable ownership. This includes not only meeting the existing obligations with respect to environmental standards and impact assessments, but also proactively seeking to address wider issues and meet voluntary guidelines, as well as anticipate regulatory change. For example, some buyout firms are taking a more proactive approach to environmental best practices with their existing portfolio companies by trying to be more resources-aware and making incremental improvements. From a social perspective, a manager leading in ESG integration will typically ensure that due diligence includes a consideration of adherence to international labour and human rights standards as well as community engagement. Furthermore, the manager will typically ensure that governance structures are in place to provide the appropriate levels of oversight in the areas of audit, risk management, and potential conflicts of interest.

A well-managed private equity program can deliver an appropriate premium to public equity returns with a reasonable amount of risk.

ESG-themed and, more specifically, environmentally themed private equity funds can promote positive environmental outcomes through the development of processes that are both more efficient and sustainable. Impacts such as the lowered raw material usage and reduced energy expenditure and waste production are some of the key positive outcomes and indirect benefits of this approach, which can lower a company's environmental impact and contribute to more sustainable economic growth. These non-financial returns, although sometimes difficult to measure quantitatively, accrue broadly. However, it should be noted that for responsible investors, careful evaluation of how ESG factors are incorporated into individual funds is critical.

## THE OPTIMAL USE OF PRIVATE EQUITY

Private equity is included in portfolios for its potential to add value over public equity investments. We believe a well-managed private equity program can deliver an appropriate premium to public equity returns with a reasonable amount of risk. There is solid academic support that the asset class has provided the necessary returns to justify its inclusion in portfolios, and there is ample room to outperform based upon manager and strategy selection. The size of an allocation within a portfolio is typically constrained by liquidity concerns more than any other factor. Although the less attractive features of private equity investing can largely be managed, the asset class will not be a fit for every portfolio.

# GLOSSARY OF PRIVATE EQUITY TERMS

**BUYOUT**
The acquisition of a controlling stake in the equity of a business. The use of meaningful debt in the capital structure of such companies is a leveraged buyout or LBO.

**CAPITAL CALL OR DRAWDOWN**
A portion of a commitment that the GP has requested to fund new investments and/or management fees and operating expenses.

**CARRIED INTEREST OR CARRY**
The profit share earned by the general partner.

**CO-INVESTMENT**
Minority investments made alongside a private equity investor in a transaction. The private equity firm involved will typically exercise control and perform monitoring functions.

**COMMITMENT**
An amount of capital that has been committed to be invested in a partnership. Such capital can be called by the GP typically upon 10-day notice. Once the partnership agreement has been executed, the investor is legally bound to fund such capital calls.

**DELAWARE LP**
Limited partnership domiciled in the state of Delaware that is governed by Delaware partnership law. The main type of US partnership.

**DISTRESSED FOR CONTROL**
Strategy of acquiring a control equity position in a financially or operationally distressed company by investing in debt and converting that position to equity via a restructuring, often via a bankruptcy process.

**DISTRESSED, NON-CONTROL**
Strategy of investing in the securities of a financially or operationally distressed company or asset and realising the value of the asset via a restructuring process. Such investors typically do not seek to be equity investors in the restructured company.

**DISTRIBUTION**
A return of capital and profits to the investors.

**EXPANSION OR GROWTH CAPITAL**
Private equity and venture capital funds aiming to grow and expand an established company, in which the investor does not typically have a control position. For example, to finance increased production capacity, product development, and marketing, and to provide additional working capital. Also associated with high-growth companies that are just turning profitable or cash-flow positive. The dominant form of investment in emerging markets.

**FEE OFFSETS**
Amounts received by a GP in the course of fund management duties that are offset against management fees due from LPs. Such fees may include transaction fees, monitoring fees, board of director fees, and advisory fees.

**FUND OF FUNDS**
A partnership that invests in other funds rather than in companies. Funds of funds are just one outsourced way of implementing a private equity program.

**GENERAL PARTNER (GP)**
The private equity management company who has unlimited liability for the debts and obligations of the limited partnership and the right to participate in its management. The GP is the intermediary between investors with capital and businesses seeking capital to grow.

**GP COMMITMENT**
Capital being committed to the fund by the GP. This is an important feature that aids in the alignment of interest with the LPs.

**INTERNAL RATE OF RETURN (IRR)**
The discount rate at which the net present value of all cash flows for an investment equals zero. This is a measurement of returns for an investor in private equity and takes into account all the cash inflows and outflows from a particular investment and the residual fair market value of the investment.

**LIMITED PARTNER (LP)**
An investor in a limited partnership — private equity fund.

**LIMITED PARTNERSHIP**
A vehicle whose participants consist of the GP that manages the private equity fund and the LPs that have committed capital to the fund.

**LIMITED PARTNERSHIP AGREEMENT (LPA)**
Governing legal agreement for an LP. It specifies the rights and responsibilities of the LPs and the GP.

**MANAGEMENT FEE**
Fees due to the GP. Fees are typically calculated as a percentage of committed capital during the investment period and a percentage of remaining capital thereafter.

**MEZZANINE DEBT**
Mezzanine debt is private subordinated debt, often issued with warrants or the right to invest alongside the equity sponsor. Mezzanine debt is often used to finance buyouts or provide growth capital.

**MULTIPLE OR TVPI**
The ratio between the total value of distributions plus NAV to total cash investment in the partnership, expressed as a multiple.

**NET IRR PERCENTAGE**
The net IRR earned by an LP to date after management fees and carry. Based upon the realised cash flows, including fees and the valuation of the remaining interest in the partnership.

**PREFERRED RETURN OR HURDLE**
Specified return the LPs receive before the GP begins to be paid its carried interest. Preferred returns range from 6%–10% with most funds having an 8% preferred return. VC funds do not typically contain preferred returns.

**PRIVATE EQUITY**
The making of equity or equity-like investments in privately negotiated transactions. A broad term that covers buyouts, venture capital, special situations, growth equity, mezzanine debt, and other similar strategies.

**SECONDARY**
Acquiring existing interests in a private equity fund from an existing LP. Secondary transactions may also consist of direct investments in private companies acquired from the original holders.

**SPECIAL SITUATIONS**
A catch-all category of strategies that do not fit into the venture capital or buyout sectors. Distressed strategies, secondaries, mezzanine debt, and asset-based strategies such as drug royalty or airplane leasing are the most common areas for special situations investments.

**VENTURE CAPITAL (VC)**
A type of private equity investment that provides capital to new or growing businesses with limited revenue or none at all. Venture funds invest in startup firms and small businesses with perceived, long-term growth potential.

## ABOUT THE AUTOR

Michael Forestner is the co-chief investment officer of Mercer Private Markets and serves on the firm's Alternative Investment Committee and the Mercer Private Markets Investment Committee. His duties include research and manager due diligence and monitoring across private equity, infrastructure, and natural resources investments. He also serves as lead portfolio manager for the Mercer Private Investment Partners series of multi-manager private market funds.

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