

Chapter 2: The Private Equity Cycle—Fund-Raising and Fund Choosing

1. What are the major subcategories of private equity, and how do their investment approaches differ?

The major subcategories of private equity consist of different types of investments, different holding periods, and different investment sizes, ranging from very small companies to multinational enterprises. Different types of private equity appeal to different investors. The limited partnership structure is the preferred organization form to link the suppliers of capital and the individuals who manage the investments (the general partners). In buyouts, investors purchase an entire publicly traded company and take it private to perform operational enhancements without the short-term demands of stockholders.

2. What are the advantages of setting up a private equity firm as an LLC?

The main advantage of setting up a private equity firm as an LLC is to limit the GPs liability. Otherwise, the GPs have the sole responsibility for sourcing and managing portfolio companies at the cost of unrestricted liability. In a firm organized as an LLC, the LLC bears the liability for product malfunctions and other unfortunate situations. The LLC becomes the general partner, and the human investors act as the organization's directors.

3. What are the four major similarities for private equity transactions?

The four major similarities for private equity transactions are:

- a. There is no public market for privately held securities, and investments in them are considered illiquid assets.
- b. The process of creating value in private equity, whether building a brand-new company or turning around an established one requires significant time and means a long-term relationship.
- c. The general partner participates actively in the governance of the investment
- d. Private equity investing is a lot of work as gaining access to better opportunities requires active sourcing and negotiation.

4. How might a GP be successful in raising a first-time fund without a track record?

A general partner (GP) might be successful in raising a first-time fund without a track record by aligning the interests of the GP with the limited partners (LPs) using a profit-sharing agreement of private equity. At the exit, the LPs receive the capital that was invested in the company and the profits are split. The LPs typically receive 80 percent and the GPs 20 percent.

5. Why would a corporation, like Intel, want to invest in private equity?

A corporation, like Intel, may have a direct venture investing division to invest in private equity to take advantage of above-market returns in exchange for low liquidity.

6. Which type of LP might be inclined to increase its private equity investment allocation going forward? Why?

Pension funds, both private and public, might be inclined to increase their private equity investment allocation going forward because they are the only ones that receive regular infusions of money from contributors.

7. What is the primary role of a fund-of-funds, and what type of investor is likely to invest in one?

Funds-of-funds help large clients access their capital across many smaller funds, and help smaller clients by providing access and diversification across a number of funds. Small college endowments, family offices, and high-net-worth individuals are likely to invest in funds-of-funds.

8. Why have funds-of-funds received criticism?

Funds-of-funds are criticized because they tend to underperform the average fund. According to a research result, the average internal rate of return (IRR) of a fund-of-funds, before any additional fees, is a negative 2 percent.

9. In the LPA, how are the interests of the LP and GP aligned?

In the limited partnership agreement, the interests of the LP and GP are aligned by several provisions: characteristics of the fund, such as its duration and investments; costs and incentives, such as the fees paid LPs and the way they are calculated, along with the level and basis for the profit share; and the activities of the GPs.

10. What is the purpose of a "concentration limit"?

The purpose of a concentration limit (the percentage of the fund that can be invested in a single company) is to guard against the possibility that the GPs may focus an excessive amount of time and additional capital on a company in which it has already invested a large amount. Another related concern involves the possibility that GPs might try to offset a large investment in a troubled company by engaging in high-risk strategies with the remainder of the fund.

11. How does the use of leverage vary among the different types of private equity firms?

The use of leverage tends to vary widely among the different types of private equity firms; however it tends to be particularly high for venture capital funds. Because GPs may be tempted to increase the variance of their portfolio's returns through leverage in order to boast their share of the profits. Partnership agreements often limit the ability of private equity investors to borrow funds.

12. Why have larger private equity firms (in terms of assets under management) come under scrutiny regarding their management fee structure?

Larger private equity firms come under scrutiny regarding their management fee structure because LPs worry that GPs will simply live off the fee streams rather than pursuing above-market returns from investing in risky companies.

- 13. If a firm with a \$5 billion fund charges a 2 percent management fee for eight years, and 20 percent carried interest on all profits, and earns a 3x return on its investments, what is the true multiple of investment and IRR for the LP? (Assume that investments are made equally at the beginning of the first through fifth years, the holding period of each investment is five years, and there are no transaction fees.)**

If the fund invests \$5 billion in a company and sells it for \$15 billion five years later, the LPs get their drawn down capital back (\$5 billion $\times$.98 = \$4.9 billion) and then receive 80 percent of the \$10 billion profit, or \$8 billion. The investment multiple is \$12.9 billion/\$5 billion = 2.58 times. The IRR is 20.9%. $[(1 + \text{IRR})^5 = 12.9/5]$.

- 14. In question 13, what if the fund is structured so that instead of having to return drawn down capital, the manager needs to return only the capital that was actually invested in companies (i.e., not including management fees). How would the investment multiple and IRR change?**

If the fund invests \$5 billion in a company and sells it for \$15 billion five years later, the LPs get their \$5 billion back and then receive 80 percent of the 10 billion profit, or \$8 billion. The investment multiple is \$13 billion/\$5 billion = 2.6 times. The IRR is 21% $[(1 + \text{IRR})^5 = 13/5]$.