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Private Equity Investments

IN THIS ISSUE

A summary of a recent Yanni Partners white paper on private equity investment strategies.

Investors pursue private equity to enhance returns. Private equity investments represent forms of equity for which there is no public market.

The main sectors are buyouts and venture capital. Buyouts are purchases of mature businesses. Venture capital encompasses investments in new companies, primarily in information technology and life sciences. The rationale for investing in private equity is to earn a higher return than traditional (public) equity securities. Two factors contribute to private equity's expected performance advantage: a liquidity premium and a skillful manager's potential to add value. The liquidity premium stems from the opportunity to buy private companies at a substantial discount relative to the public markets to compensate the investor for the lack of liquidity and other attendant risks.[1] A private equity manager's potential to add value arises from the manager's ability to improve a company's perceived worth.

Some analysts cite diversification as an additional reason to invest in private equity. We disagree. Short-term performance data from private equity funds suggest low performance correlations relative to public markets. These results are illusory. Private equity returns often suffer from distortion of "stale" prices due to the lack of current pricing. We believe that private equity investments experience high correlations with public markets because both private and public firms are subject to the same economic and financial forces. An investment in private equity must be justified solely on the expectation of higher returns, not diversification.

Private equity investments are suitable only for long-term investors who can afford to sacrifice liquidity, for a portion of their funds, for many years.

Access to well managed funds is a prerequisite for success in this sector. Many private equity funds have not compensated investors for the lack of liquidity and incremental risks. In contrast, however, well-managed "top-tier" funds have significantly outperformed public markets.

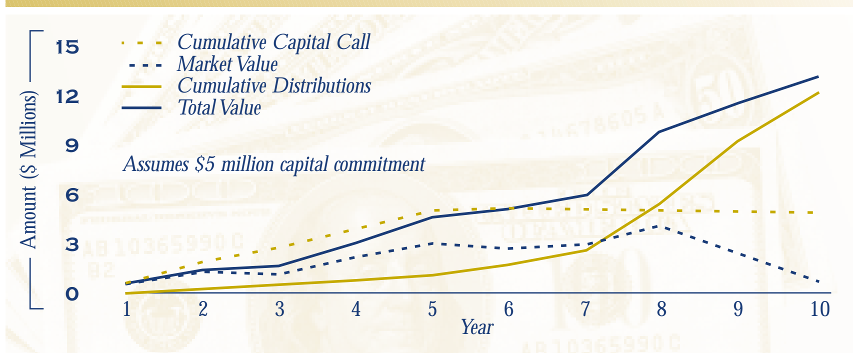
Private Equity Investments

Private equity investments provide investors with the opportunity to hold interests in private companies. These investments fall into two broad groups: buyouts and venture capital. Many buyouts represent small to mid-size mature businesses (typically in sectors such as distribution and manufacturing) that cannot access the public capital

Note:
[1] There are no deep, daily public markets for exits.

FIGURE ONE

Private Equity Cash Flows and Values



markets. Opportunities to buy such companies arise from the following circumstances:

- Private companies seek expansion capital.
- Owners of private companies decide to sell.
- Large companies seek to sell certain operating divisions that no longer fit within the parent company's strategic plans.

Venture capital involves ownership of start-up companies, typically in information technology and life sciences. Venture capital serves as the primary source of funding for new companies that require large investments in intellectual property. Managers of venture capital partnerships also provide crucial management support.

Investment Rationale

A skillful manager generates value through two primary sources: (a) a valuation arbitrage, and (b) the improvement in operating performance and business prospects. Valuation arbitrage occurs because the manager strives to buy a company for a much lower valuation than the valuation embedded in the sale price.[2] The manager buys the company in the private market where companies sell at a 30% to 50% discount to public market valuation. The manager endeavors to sell the company in the public market or in a strategic sale for a much higher valuation.

Note:

[2] An industry convention is to express price as a multiple of cash flow — typically defined as earnings before interest, taxes, depreciation, and amortization.

The manager enhances the company's prospects by recruiting capable management, providing strategic advice, conserving capital with sound financial planning, improving the balance sheet, implementing effective management controls, and selecting an opportunistic exit strategy (such as finding a strategic buyer or arranging an IPO during a favorable market environment). Enhancing the operating performance of a company will increase its earnings and cash flow, thereby adding to the exit valuation.

Access to Skillful Managers

Access to a skillful fund manager is a prerequisite for success in private equity investing. This "access" requirement is unique to private equity. In the public markets, an investor can achieve competitive returns (relative to professional investment managers) through passive and buy/hold strategies. Private equity, in contrast, requires intensive, "hands-on" management.

Investment Vehicles

The most common investment vehicle for buyout and venture capital portfolio companies is a limited partnership. The investment manager typically assumes the role of the general partner. The general partner contributes capital (at least 1%) and assumes unlimited financial liabilities. The general partner performs all portfolio management functions:

- Organizes the partnership and formulates the investment strategy.
- Identifies, screens (performs due diligence), and selects portfolio companies.
- Provides strategic advice to the companies.
- Serves as liaison with the passive investors (limited partners).
- Develops and executes the strategy to achieve liquidity for portfolio holdings.

The exit strategy provides the method to achieve liquidity for each portfolio holding. Exit strategies for buyouts and venture capital include sales to strategic buyers (typically a larger company), mergers, and public listings.

The general partner receives compensation for its efforts in organizing/managing the fund and for assuming unlimited financial liabilities. General partners charge two levels of fees: an annual management fee (typically 1% - 3% of committed capital) and a portion of the partnership's profits (typically 20%), known as "carried interest." Many funds stipulate that carried interest payments must be based on net profits after all losses, fees, and expenses. Limited partners provide capital and serve as passive investors. Most limited partnerships share similar terms and structural characteristics:

Term - typically 10 years, with provisions to extend the term for several years (pursuant to approval from the limited partners) if the general partner concludes that market conditions warrant an extension. The partnership distributes cash from realizations (from sales) and shares from IPOs prior to the end of the term.

Fees - limited partners pay a management fee to the general partner based on committed capital. Some partnerships reduce the base to invested capital after several years. This fee typically ranges from 1% to 3% per annum.

Carried Interest - the general partner receives a percent of the profits, typically 20%, net of all losses, fees, and expenses. Many partnerships require the fund to achieve a minimum "hurdle rate" return before the general partner receives a portion of the profits.[3]

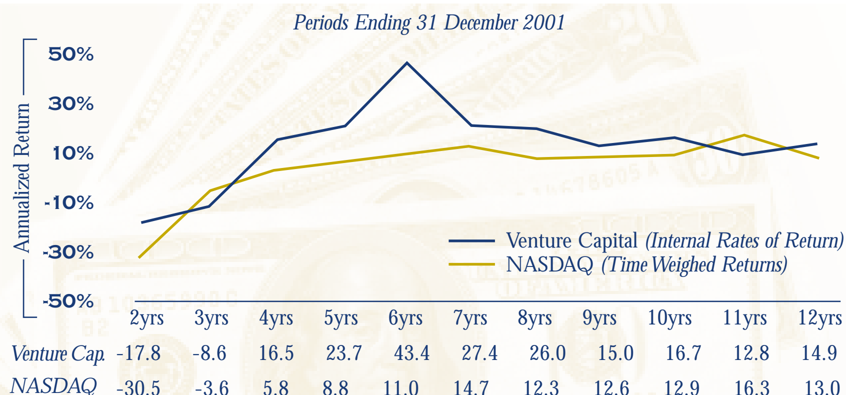
Operating Expenses - the fund typically pays administrative and operating expenses such as auditing, custody, and legal fees. The general partner's direct expenses such as salaries, benefits, rent, etc. are not borne by the fund - the general partner pays these expenses directly.

Liquidity

A major limitation of private equity is limited liquidity. The general partner will distribute cash and securities (in kind transfers) following the realization of successful investments. Distributions typically occur during the later half of the fund's term.

FIGURE TWO

Annualized Venture Capital and NASDAQ Returns



	2yrs	3yrs	4yrs	5yrs	6yrs	7yrs	8yrs	9yrs	10yrs	11yrs	12yrs
Venture Cap.	-17.8	-8.6	16.5	23.7	43.4	27.4	26.0	15.0	16.7	12.8	14.9
NASDAQ	-30.5	-3.6	5.8	8.8	11.0	14.7	12.3	12.6	12.9	16.3	13.0

Note: Venture capital data are median returns from Thomson Financial Venture Economics

Figure One illustrates investments, distributions, market values, and total value (market value plus distributions) in the case of an investor who commits $5 million to a private equity fund.

Who Should Invest

Private equity is suitable only for long-term investors who fully understand the risks and liquidity limitations of private equity. Many pension plans, educational institutions, foundations, and health care organizations include private equity as a component of a well diversified investment strategy. An organization's commitment to private equity should range between 5% to 15% of the total fund. An investment below 5% will not have a material effect on the fund. An upper limit of 15% will help

Note:
[3] The "hurdle rate" is sometimes known as the "preferred return."

FIGURE THREE

Annualized Net Returns (%) to Investors as of 12-31-01

Stage	1 Year	5 Year	10 Year	20 Year
All Funds [A]				
Venture Capital	-27.8	35.9	26.4	17.7
Buyouts	-13.4	5.2	10.9	13.9
All Private Equity	-18.5	14.8	17.3	16.2
Top Quartile Funds [A]				
Venture Capital	-31.3	82.8	45.3	28.8
Buyouts	5.0	21.9	30.8	39.4
All Private Equity	-8.1	46.8	39.1	31.6
Public Equities [B]				
S&P 500	-11.9	10.7	13.0	15.2
Russell 2000	2.5	7.5	11.5	12.0

Notes: [A] Internal rates of returns / [B] Time weighted returns *Source: Thomson Financial Venture Economics*

Measuring Up

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protect the fund against the unique risks associated with private equity.

Historical Returns

An investment in private equity must be justified solely on the expectation of higher returns, not diversification. Private equity investments experience high correlations with public markets because both private and public firms are subject to the same economic and financial forces. Contemporaneous return series of private and public equity markets sometimes suggest a low correlation. The appearance of this low correlation stems from the pricing lags inherent in private equity markets that lack current prices. The close economic relationship between private and public equity market performance becomes more apparent when one evaluates returns over long periods. *Figure Two* compares returns for venture capital to an appropriate public market benchmark, the NASDAQ Index, for progressively longer periods ending 31 December 2001. Over short periods, venture capital and NASDAQ returns diverge. Over longer periods, the two series begin to converge.

Buyout and venture capital funds have generated skewed return patterns. Top quartile (and some second quartile) funds have outperformed public equities by wide margins. These highly successful funds have amply awarded investors for the risks and liquidity limitations inherent in private equity. Many funds have failed to compensate investors for their incremental risks. *Figure Three* displays returns of private equity sectors over short and long periods.

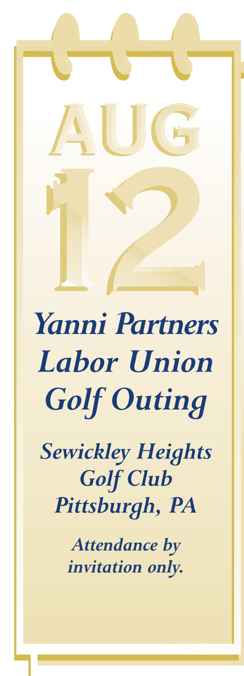
Summary

Private equity offers the prospect of a significant performance premium relative to public equities. It is reasonable to expect an annualized return premium of 400 to 600 basis points from a well-managed private equity program over the long term. Sources of this performance enhancement are the expected liquidity premium from investing in non-liquid equities and a manager's ability to add value by enhancing the company's operating performance. The drawbacks are complexity and limited liquidity.

We believe that private equity investments may offer an attractive source of incremental returns, if two conditions are met: (a) the investor obtains access to highly skillful private equity managers, and (b) the investor diversifies the private equity portfolio broadly among numerous partnerships.

This article was written by David Hammerstein, CFA, Chief Strategist with Yanni Partners.
Mr. Hammerstein received a BA from Colgate University and an MBA in finance from the University of Chicago.

Calendar of Events



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