

# An Introduction to Private Equity

Private equity funds invest in the equity of companies that are not publicly traded. Some of the primary strategies employed by private equity funds may be used to develop new products and technologies, to expand working capital, to make acquisitions, to strengthen a company's balance sheet or to take a public company private.

*Private equity fund investing is a strategy that has rewarded patient investors.* Private equity returns (Source: Thomson Venture Economics) have been higher than those available from traditional public equity markets (as compared to the S&P 500 index) over comparable time periods. For the 10-year period ending December 31, 2008, the S&P 500 index had returned -1.4%, and private equity funds 8.6%. These higher returns are generally attributable to lower valuations in private markets and a focus on long-term growth rather than meeting short-term earnings expectations as sometimes seen in the public equity markets.

*Private equity funds may also provide some diversification benefits to a portfolio.* Private equity returns are realized mostly through private sales to strategic and financial buyers and, to a much lesser degree, through public offerings (IPOs). These sales, and hence returns, are not directly dependent on more volatile valuation parameters that can drive public markets. The fund managers also control the timing of liquidity, selling only when they feel they have found the best private or public channel to liquidate their interest in the investment.

## WHAT IS PRIVATE EQUITY?

The term "private equity" covers a wide spectrum of activities, ranging from venture capital at one end to various forms of corporate finance at the other. Private equity may involve the acquisition of a private company with the intent of providing its founders the capital necessary to improve the firm's performance. Or it may involve "privatizing" a public company in an effort to undertake improvements that would be difficult to achieve, given the short-term earnings focus of the public markets. Some of the more common private equity fund strategies include:

- **Leveraged/Management Buyouts (LBO)** — Acquiring mature companies using a certain amount of borrowed money (leverage) together with private equity.
- **Venture Capital (VC)** — Financing start-up companies or early stage businesses with high growth potential in exchange for ownership.
- **Mezzanine Debt** — Using debt with equity options to finance established private companies that prefer to raise additional capital without giving up as much ownership as required by equity financiers.
- **Distressed Debt** — Acquiring debt securities, sometimes with equity features, of companies in bankruptcy proceedings or other serious reorganization.



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## *An Introduction to Private Equity, continued*

### **Private Equity Terms to Know**

*Limited Partner* — An investor in a private equity fund.

*General Partner* — The investment manager of a private equity fund.

*Capital Commitment* — The total dollar amount of a limited partner's desired investment.

*Capital Calls* — An investor is typically required to fund only a small percentage, if any, of their total capital commitment at the outset. Rather, the capital commitment is drawn over several years through a series of “capital calls,” which are issued as cash is needed for investment. Typically, the investor receives notice of the capital call two to three weeks in advance of the date when the funds are required.

*Vintage Year* — The “vintage year” is typically the calendar year in which the private equity partnership accepts commitments from limited partners.

*Vintage Year Diversification* — There can be a wide range of returns from one vintage year to the next for the same private equity fund manager. Therefore, it is important to invest consistently year over year, rather than try to “time the market” by making a one time investment.

*J-Curve* — In the early years, investment returns from private equity are negative due to management fees, which are drawn from committed capital. It can take several years for the portfolio valuations to reflect the efforts of the general partners.

### **THE RISKS OF PRIVATE EQUITY**

It is important to understand that private equity funds involve certain risks that are unique when compared to traditional investments. Private equity funds:

- Often engage in leveraging and other speculative investment practices that may increase the risk of investment loss;
- Are highly illiquid; the typical holding period is 10 years.
- Are not required to provide periodic pricing or valuation information to investors;
- May involve complex tax structures and delays in distributing important tax information;
- Are not subject to the same regulatory requirements as mutual funds, and hence, may not provide as much disclosure;
- Often charge high fees.

Please review the section “Certain Risks of Private Equity Funds” for more information.

### **INTRODUCING FUNDS OF PRIVATE EQUITY FUNDS**

Spreading risk among a variety of private equity fund strategies and managers may be an effective way to further reduce risk and achieve more consistent returns for the portion of your investment in this asset class. Some private equity fund strategies perform better than others under certain market conditions. Funds of Private Equity Funds provide a vehicle for investing in multiple private equity fund strategies and managers.

## *An Introduction to Private Equity, continued*

### **A POWERFUL RESOURCE**

Because there is little public information available on private equity funds, investors often turn to fund of private equity funds managers with specialized expertise and resources in evaluating and managing private equity funds. Fund of private equity funds managers seek to build key relationships with private equity fund managers, fund administrators, prime brokers, and other professionals knowledgeable about the private equity fund industry. The more proficient fund of private equity funds managers work to leverage these relationships to gain valuable insights and access to industry veterans and information.

In addition, fund of private equity fund managers may also provide the following services:

- *Establish the allocation* of the various private equity fund strategies and styles to meet the fund of private equity fund's investment objectives.
- *Implement a rigorous manager selection process* that includes both quantitative and qualitative aspects. There are normally hundreds of private equity funds raising assets in a given year. Reducing this number down to a more manageable universe and then conducting due diligence requires resources and many years of practical experience. It is common to see a combination of 20 or more different private equity fund managers included in a diversified fund of private equity funds, each with a unique approach to investing.
- *Apply a well-disciplined, methodical approach to monitoring investments.* This includes resources dedicated to ongoing reviews as well as periodic on-site visits with the managers.

### **INCORPORATING PRIVATE EQUITY INTO YOUR PORTFOLIO — INVESTMENT CONSIDERATIONS**

To determine if investing in private equity funds is right for you, and, if so, to create an appropriate asset allocation to private equity funds, you must consider several different factors including:

- Your overall financial objectives
- The size and allocation of your portfolio
- Your risk profile
- Your investment time horizon

Your Financial Advisor can work with you to determine if investing in private equity funds is appropriate for you and, if so, a suitable allocation.

### **CERTAIN RISKS OF PRIVATE EQUITY FUNDS**

Private equity funds are investments that carry substantial risks. For these reasons, they are only appropriate for sophisticated, experienced, high net worth investors. Many of the specific risks inherent in private equity fund investing are defined below.

#### **Leverage**

Private equity funds often engage in leverage and other speculative investment practices, which may increase the risk of investment loss. The value of an investor's interest in a private equity fund may be subject to great risk from a minor change in market conditions or trends. Loss of all or substantially all of a private equity fund investment is possible.

#### **Limited Liquidity**

Private equity funds offer limited liquidity. There is typically no secondary market for interests in a private equity fund. The investment term typically ranges from 10 to 12 years. Fund redemptions are usually not permitted. You should review the offering documents with your legal and/or tax advisor and ask your Financial Advisor for clarification about the terms of the underlying investment if you are unsure.

## *An Introduction to Private Equity, continued*

### **Management Control**

Investors have no ability to influence the management of a specific private equity fund or fund of private equity funds.

### **Tax Implications**

Private equity funds may involve complex tax structures and delays in distributing important tax information. Consequently, delays in reporting of tax information can affect an individual investor's ability to timely file tax returns. You may wish to speak to your tax advisor about the potential effect of such delays.

### **Different Regulatory Requirements**

Private equity funds are not subject to the same regulatory requirements or oversight as mutual funds. Specifically, many private equity funds are not registered as investment companies and are offered through unregistered private placements. Consequently, these investments are not subject to the same regulation, net capital or reporting standards as registered investment companies (like mutual funds).

### **Higher Fees and Expenses**

Private equity funds and funds of private equity funds often charge high fees and may be subject to high operating expenses relative to more traditional investments. These fees are commonly charged based on the capital commitment, not the assets under management in the fund. These fees may be charged outside of the fund. These fees can include a provision for the fund manager or sub-managers to receive a significant percentage (20% can be typical) of net profits generated by the fund. Please read the offering document carefully and speak to your Financial Advisor about any questions you have regarding the fees associated with any private equity fund or fund of private equity funds investment.

### **Capital Calls**

Private equity funds drawdown an investor's capital commitment on an as-needed basis. Failure to make a required capital contribution may result in substantial economic and other penalties, including forced sale at unattractive terms.

### **Investments**

Private equity funds may make investments in funds and companies with short operating histories, few key operating principals and managers, and may be organized and operated outside of the United States under regulations very different than in the United States.

### **Valuations**

Investments made by private equity funds are generally held at cost until a material event changes their value.

*This material is intended for use by qualified investors only. RBC Wealth Management defines qualified investors as those with the knowledge and experience to evaluate the merits and risks of a speculative and illiquid investment. In addition, the investor must be in a financial condition that will permit them to bear the risk of such an investment. Generally, the investor must have a net worth of \$1 million and assets of \$5 million. For additional information regarding any specific private equity fund investments, refer to the offering document.*

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