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What Is Private Equity?

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Private Equity Fund

Investments that do not classify as either equity or fixed income are often referred to as "alternative investments." One that has gained a lot of attention recently is private equity. Back in June, the Department of Labor approved including the asset class in 401(k)s and other defined contribution retirement plans[1].

This announcement generated a lot of press, and investors are now asking how private equity works and if this mysterious asset class is right for them. To answer these questions, let's walk through a hypothetical example to better understand the structure and the key players involved.

Imagine five seasoned executives skilled at building manufacturing companies team up. Their goal is to seek out firms that exhibit potential but are struggling to grow. They form an investment fund to buy "private" companies, or those whose stock is not listed on a public stock exchange. These five executives are considered the "general partners," or GPs for short, because they are responsible for managing the fund.

These executives carry decades of experience and are confident that they can help companies grow. They also know that they cannot simply tell existing management what needs to be done. Instead, they need control over the day-to-day activities such as operations, financials, personnel, etc.

Few companies will just hand over the reins to outsiders, so the team is going to have to buy enough of each target company's stock to where they have control. These purchases can take hundreds of millions of dollars, so they raise money from two primary sources.

The first is from traditional bank loans, where the GPs borrow funds from multiple banks and pay interest on these loans over time. The second is from outside investors who are willing to share in the risk for a piece of the return. They are called "limited partners," or LPs for short, because they have limited involvement in the fund.

The LPs rarely give all of the committed capital up front. Instead, the GPs will do a "capital call" periodically as they encounter investments along the way.

For example, if a pension fund committed $10 million to a private equity fund on Year 1, they normally would not deposit any cash then. If the GPs found an investment in Year 2 and "called" 20% of the capital from all the LPs to buy the target business, the pension fund would then send a check for $2 million ($10 million x 20% = $2 million) representing their share of the investment.

Once the GPs secure the capital from banks and LPs, they need to hire personnel, rent office space, and do everything else a company needs to do to stay in business. In order to pay for it all and to compensate the GPs for doing the heavy lifting, they charge the LPs a management fee.

This fee ranges between 1% to 2% annually, so if the fund calls $50 million from LPs and charges a 2% management fee, then the GPs would use $1 million of the funds called ($50 million x 2% = $1 million) to pay its expenses in the first year.

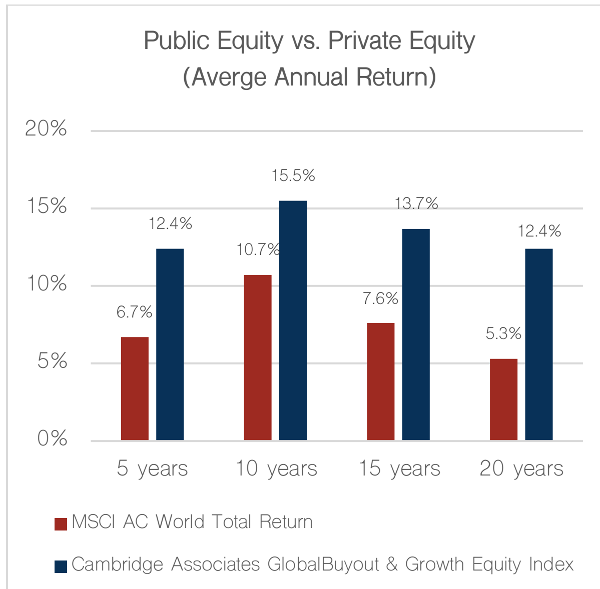
The GPs do not work as hard as they do just to earn a management fee. Instead, their goal is to profit from the sale of the fund's investments. For example, if this fund invested $20 million of the capital raised into a small manufacturing company that was sold five years later for $200 million, then both the GPs and LPs will realize a big return on their investment.

The profit split between the two partners varies, but the industry average is 20% to the GPs and 80% to the LPs. The percentage that GPs keep is called the "carried interest," which can add up to huge amounts of money.

For example, if the profits from the sale of this investment were $150 million after the debt was paid back, the GPs and LPs keep the rest. The GPs take home $30 million ($150 million x 20% = $30 million), which in this case gets split amongst five people.

Public vs. Private

The chart below compares the average annual return of the Cambridge Associates Global Buyout & Growth Equity Index (a measure of private equity industry performance) to the MSCI World Total Return index (a measure of global public equity market performance). Based on these indices, private equity has more than doubled the return of public equity over the last 20 years.



Sources: *Cambridge Associates, Prequin, Standard & Poor's, World Federation of Exchanges, J.P. Morgan Asset Management. Global Buyout & Growth Equity and MSCI AC World total return data are as of December 31, 2018.*

These impressive returns are due to a number of factors, but arguably the most important is control. The GPs roll up their sleeves and get their hands dirty. They can replace management, change the strategic direction of a company, sell off unprofitable business units, etc.

Furthermore, private equity can be incredibly sophisticated and often requires a team of seasoned executives who spent years cutting their teeth in an industry. This creates high barriers to entry when compared to public equity markets.

However, this control comes at a price. When an investor buys a publicly traded stock, that transaction is conducted in seconds on a highly regulated stock exchange. Private equity deals take months, sometimes years to complete. Both sides spend real money on lawyers and experts in everything from valuation and earnings quality to human resources (costs that are rarely recouped if a deal falls through).

Another challenge with private equity is the time horizon. Most investments require capital to be locked up for at least 5-7 years, and investors are often required to invest additional capital along the way.

The Bottom Line

Direct investment into private equity funds has historically been restricted to institutions and ultra-high net worth investors for several reasons. First, regulators require LPs to be "accredited investors." This condition states that either an investor's net worth exceeds $1 million (excluding a primary residence) or annual income exceeds $200,000 for individuals or $300,000 joint with spouse in each of the last two years.

Second, gaining access is not easy. Often times, a prospective LP can only get in by knowing the right people or by bringing more than just capital to the fund, such as specific expertise that the GPs can use.

Lastly, three major hurdles to controlling risk further complicate investing in this asset class. The first is the cost. Mutual funds and exchange traded funds (ETFs) offer lower-cost accessibility for diversification in stocks and bonds. For example, a single equity ETF can diversify an investor across every major sector and geography.

The closest equivalent in private equity is a "fund of funds." Think of this as an investment fund that pools capital and uses it to invest into multiple private equity funds (similar to a mutual fund holding several assets). This approach can provide diversification with lower minimums, but the cost is an added layer of fees.

The second challenge can be the amount of capital needed to properly diversify. Investors that opt to build a private equity allocation themselves need to commit to several funds. This can easily exceed $10 - $25 million of capital when minimum investments start at $1 million.

For example, an investor who wanted to invest 10% into private equity, but did not want to use a fund of funds because of the added fees, would need their portfolio to be a minimum of $100 - $250 million in size.

The third is the difficulty in picking suitable investment options because high returns don't exist without a commensurate level of risk. Handing over millions to a lightly regulated group of GPs demands that a prospective investor do their homework to ensure the team is legitimate and the strategy is sound. Few investors have the experience to conduct this due diligence.

The bottom line is that private equity has historically delivered strong returns, but there are no free lunches. The high minimums, lack of liquidity, sophistication, and difficulty managing risk create insurmountable barriers for most investors. Approving private equity into retirement plans is a good first step, but many of these hurdles will likely remain for some time.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Sources

1 https://www.wsj.com/articles/u-s-labor-department-allows-private-equity-in-401-k-plans-11591229396

Disclosures

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