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The Fundamentals of Private Equity Investing

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by **Merry Sheils** on Living Around

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Recent market chaos has caused many of us to crawl into a cave hoping that when we have the courage to come out, all will be calm and settled. Unfortunately, investing doesn't work that way, as many of us now know more than we'd like.

A vital factor in withstanding market gyrations is asset allocation, based on the underlying fundamental principle of correlation. Different asset classes (stocks, bonds, commodities) behave differently in relationship to one another. The best-performing portfolio combines various asset classes that are uncorrelated, so that when one or more are struggling, some are not. In a nutshell, and over time, that is the best risk-management strategy.

One asset class that can have a low correlation to others is private equity, defined as investments in non-public companies. Examples of successful private equity are abundant: most major Silicon Valley companies (yes, Apple Computer is one) began as some sort of private equity company, where brave people with money saw the promise, ponied up significant dollars and management expertise and lived to see rich rewards. But not always. Sometimes, the deals are duds, and instead of collecting fat checks, investors cut their losses. And some, like Michael Milken, go to jail. Such is the nature of investing.

The profits to be had are enticing: a hefty management fee, that can run to 2%, plus a percentage of the performance over a pre-determined benchmark (known as the “carry”). It’s not unusual for investors to earn three or four times their investment upon exit – 3x and 4x in private equity parlance – and receive favorable capital gains tax treatment to boot. Not a bad gig. (So much so that our current administration is lobbying to have these profits taxed at a more equitable ordinary income rate).

Private equity, by definition, is limited to those among us who can afford to lose our collective shirts – the theory being that if you have an extra million or so in your piles of millions, you won’t feel the loss. So, generally, a $5 million net worth with significant investible assets (that means no residential real estate can be used in the calculation) is the norm.

Similar to how equities are categorized (large, small, domestic, international), private equity also is subdivided into a few primary types: buyouts, venture, growth and special situations are some of the more common ones. Some private equity companies create funds of investment capital to specialize in these or other strategies. A typical fund will have sometimes 30 or more underlying portfolio companies, and for somewhat obvious reasons. Out of that 30, some will naturally fail. Some will perform reasonably well, and a few will be winners. You begin to get your capital back in what is known as an exit strategy. That is when one or more of the underlying companies is either 1) sold to another company or taken public; or 2) refinanced.

Buyout deals occur, for example, when a division of a company is spun off. A private equity group believes it can restructure the company (READ: cut costs by laying off people) make it profitable, and then sell it to someone new in a few years. It uses the company's own cash flow to service the debt needed to pay for the acquisition. The downside (and every investment has one) is that in a credit crunch, banks are reluctant to lend, so new buyers are sidelined until conditions ease. The exit is put on hold until conditions improve.

Venture deals are how most new companies are started, or if already up and running, are expanded. Think of technology companies – Facebook and Google and, more recently, LinkedIn, come to mind. All were started by someone, then venture dollars helped them grow to the point where they were ready for an IPO (initial public offering) that made their founders rich beyond their fondest dreams while the rest of us sat by and salivated on the sidelines.

Growth Capital is a way for an already mature (and oftentimes public) company to get the cash required to make a major expansion, enter a new market or embark on a new acquisition. Their existing cash flow, which may be sufficient to run a healthy business, may be inadequate to fund these new business lines. A PIPE (private investment in public equity) can be a viable solution.

Special Situations (also known as Distressed) means what it suggests: a company that is struggling, even in bankruptcy, but has a viable business model, is an attractive situation for a private equity firm. With a cash infusion, the problems go away, and the company can thrive.

So can the investors, so long as they have patience. Private equity takes time. While some investments have short-term returns, that is not the norm. Ten years is the usual time horizon. The structure includes 3 – 4 years of capital calls in which the investors must come up with a share of the total commitment. Then he or she waits to 1) realize profits or 2) recognize write-offs (not every deal works).

And, there is no liquidity during that time. Unlike a hedge fund that will allow an investor to take out money with ample notice (usually once each quarter), a private equity fund warns investors upfront that there is no opportunity to take out money at any time. The only time checks are mailed is when a portfolio company is sold or refinanced, and then you receive your proportionate share. So, if you end up wanting out, expect to take a significant “haircut” on your investment – sometimes as much as 50%. Ouch.

In an interesting twist in the realm of private equity, one company, Accretive Capital Partners LLC, of Madison, Connecticut, looks for well-run, but undervalued public companies, that may be more attractive as private companies. According to founder Rick Fearon, “Smaller companies shoulder the same expenses to be public as their larger brethren. These costs include SEC filings, compliance with the 2002 Sarbanes-Oxley Act, investor relations salaries, directors’ and officers’ insurance, and managerial time and distraction from day-to-day operations. The $1 to $1.5 million in costs associated with being a public company are equivalent to 1% to 1.5% of a $100-million company’s market cap”, according to Fearon. “By going private, these fees instead can go directly to the company’s bottom line”.

How do you select private equity companies? We all have heard of the big players, like Carlyle and Kohlberg, Kravis & Roberts (KKR). However, most of us will never be invited to play in that sandbox. But, obtaining referrals from satisfied investors is a good start. Also, most brokerage firms offer investments in funds of private equity funds, which is a way to spread the risk among various types of managers. Carefully study the prospectus and be comfortable with the strategy.

However, be aware that investing in fund-of-funds carries another layer of fees. The first layer is for the original fund manager. The next layer is paid to the group who organizes various managers into the fund-of-funds structure. The argument to substantiate the fees is access: without the fund-of-funds structure, if you have fewer than significant dollars to invest (say $10,000,000 and up) you may not have the opportunity to play in the big leagues. A fund-of-funds gives you access to managers for whom the size of your investment otherwise would not qualify.

Due diligence on the fund manager is key (just like in any investment) and knowing his record of the percentage of successful exits is vital. Be aware that a private equity portfolio may likely have companies that for whatever reason do not succeed. That is natural. But you want your manager to have a solid record of investment wins and returns to back it up.

Because of their very nature (ergo the word 'private'), information can be hard to come by, particularly on the underlying portfolio companies. Research boutiques have emerged to fill this gap. According to Bo Bruskern, President of Arcstone Partners, in Denver, CO, "The private company market is one of the most challenging – and rewarding – environments for investment research. Private companies have nuances in their capital structure that one never finds in the public markets; beyond that, their valuations can be uncertain and highly volatile. Information is almost never made publicly available, making research at times a guessing game. Yet fundamental analysis still exists: spectacular companies can be identified, analyzed and diligenced. The challenge is to achieve conviction under uncertainty. It is not for the faint-hearted."

We cannot help but agree.

The above is not meant to be investment advice. Consult your financial advisor or other investment professional to determine which types of investments are best for you.

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