MASTERING PRIVATE EQUITY

Transformation via Venture Capital, Minority Investments & Buyouts

Claudia Zeisberger Michael Prahl Bowen White

Foreword by Henry Kravis, Co-Chairman and Co-CEO of KKR

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CONTENTS

LIST OF CONTRIBUTORS

Our distinguished Guest Authors made time to share their experiences and at times critical comments, thereby adding a practical perspective to our writing. We are grateful for their support and list them in order of appearance.

Henry R. Kravis, Co-Chairman & Co-CEO of **KKR** kindly agreed to write the foreword for this book and we appreciate his thoughtful contribution on the evolution of private equity over the years.

The views expressed in the guest comments are the opinion of the respective author and not necessarily that of their firms and organizations.

FOREWORD

Henry R. Kravis, Co-Chairman and Co-CEO of KKR

What is private equity? Given you're reading this book, I'm certain this is a question you'd like to have answered.

To define the asset class properly is not as simple as looking it up in a dictionary or conducting a quick search on the internet. To do so would give you some version of private equity is capital that is invested privately. Not on a public exchange. The capital typically comes from institutional or high-net worth investors who can contribute substantially and are able to withstand an average holding period of seven years.

But private equity is so much more than its literal definition.

The way I would describe private equity, or PE, today is an asset class delivering market-beating investment returns that has grown college endowments and enhanced the retirement security of millions of pension beneficiaries, including teachers, firefighters, police and other public workers. Just as important, private equity does this by helping companies grow and improve, starting from day one of an investment.

Different firms approach this in different ways, but consistent among them is the first enduring principle of private equity: alignment of interest. This refers to alignment between a company's management and the firm investing in it, but it also means alignment between the firm investing and its own investors.

At KKR, once we make an investment, we work with a company's management team to improve the balance sheet, margins, operations, and, importantly, their topline. These actions may seem obvious steps in how to create successful companies today, but when George Roberts, Jerry Kohlberg and I co-founded KKR a little over 40 years ago, they were not.

In the '70s and '80s, companies were less concerned with these efficiencies, perhaps because management was focused on other things. To help solve for this, when we were getting started, we instituted management ownership programs, a concept that was not typical in those days. Running a company as an owner unlocks value and this alignment of interest impacts company profitability substantially. I remember a board meeting at one of our investments in the '80s, a business in the oil and gas industry, where management recommended a $100 million oil exploration budget. Our first reaction was that they must be quite optimistic about their prospects to risk that much of the shareholders' capital. We pointed out to them that as shareholders who owned 10% of the company, they were putting $10 million of their own capital at risk. Moments later, management decided to reconsider the budget. One month later, the exploration budget had been cut in half, and they were acutely more focused on the results of each and every drilling site.

The opportunity to improve companies, the ability to have an alignment of interest with management and us being the shareholders with long-term, patient capital—to me, these are the hallmarks of private equity.

And while we have been focused on delivering exceptional long-term investment returns from the outset, private equity has evolved quite a bit since we started out four decades ago.

After leaving Bear Stearns to start our own firm, we had $120,000 between the three of us—$10,000 each from George and me, which was about all we had at the time, and $100,000 from Jerry who was 20 years our senior. With $120,000 in the bank, we went to raise our first fund, a $25 million private equity fund. Keep in mind there were no such funds in those days and there was no one doing what is now considered private equity. Given this environment, we had a difficult time raising the $25 million on terms that we felt made sense. So we had a thought: Why don't we go to eight individuals and ask them to put up $50,000 each for a five-year commitment and in return, we'd give them the ability to come into any of our deals. And if they did invest, we'd take 20 percent of the profits—what is known today as carried interest.

How did this happen? George's father and my father were in the oil-and-gas business where, in those days, there was something called "a third for a quarter." If you had a lease and wanted to drill, you put up 25 percent of the cost and found someone to put up the remaining 75 percent of the cost. Consequently, that person gets a two-thirds interest for what they put down and you get a one-third interest. When applying this concept to our own business, we thought 20 percent was close enough to third for a quarter, and that's still the standard today.

When we first started doing deals, private equity transactions, better known as leveraged buyouts at the time, were in their infancy. The PE industry as we know it was not yet born. In fact, we never imagined we'd ever use the term "industry" when talking about what we do.

Private equity deals looked very different than they do today. The asset class was new, and so too was its level of sophistication. As PE explored elaborate capital structures, new sources of funding, larger pools of equity capital and did so through variable economic conditions, we did not properly explain these complexities—or our mission—to the public. As a result, PE deals became associated with hostile takeovers at the time. Referring to PE as "corporate raiders" or "barbarians," the public's reaction to the very same question I asked you—what is private equity?—was simply: an investment vehicle to acquire, strip and sell an asset for profit. We never thought of it this way; we were always focused on the opportunity at hand to create value at the companies in which we invested. Nonetheless, we and others did not pay enough attention to communicating this with our various stakeholders.

Looking back 40 years later, this is one of the many lessons, perhaps the hardest, that we've learned along the way. These lessons—and the headlines referencing barbarians that came with them—are not exclusive to KKR. The experiences of the early days of PE served as a catalyst for transformation of the entire PE industry.

I think it is safe for me to speak on the industry's behalf when I say we have learned there is so much more to investing than buying low and selling high. As my colleague Bill Cornog will expand upon in Chapter 13, we've learned to think of ourselves as industrialists. When we buy a company, we ask ourselves: what can we do to make it better? How can we create value? What constituents should we be mindful of and will factor into a good outcome for everyone?

At KKR, key to answering these questions is the development of what we call 100-Day Plans. These plans are put into place as soon as we make an investment. That means we hit the ground running from the day a transaction closes. Our goal is to focus, with a sense of urgency, on the creation of value. As part of this process, we establish upfront operating metrics. These can often reveal underlying problems with a business before those problems can be seen in the financial data. In this way, we can make difficult operational and personnel decisions as early as possible in the process. Recognizing, acknowledging and addressing problems up front are part and parcel of the successful ownership model.

This value creation process involves not only understanding a company's balance sheet and financial statements, but also its employees, their impact on the world around them and being good participants in community life. This all contributes to value creation—or destruction.

As an industry, we've learned that we can make a difference by integrating our performance-focused investment philosophy with environmental, social and governance (ESG) initiatives. It is our responsibility—not only to serve our investors through great investor returns—but also to support them by investing in the communities of the corporations in which we invest. Over the years, I think the PE industry has picked up on this quite a bit.

And while that doesn't mean every company we invest in is advancing an ecological solution, I believe PE-backed companies can help solve challenges—economic or otherwise—in their communities. Whether it's improving municipal water treatment facilities, funding sustainable economic initiatives in underprivileged communities or reducing waste and promoting eco-efficiency in plants and factories, incorporating ESG practices has become a focal point throughout the lifecycle of an investment.

As I mentioned earlier, one of the key principles to making this work is the alignment of the interests of all parties—managers, investors and employees alike.

Investing alongside one's investors, or our limited partners (LPs), is the best demonstration of partnership. While the principle of alignment has not changed from four decades ago, it has definitely been emphasized more greatly in recent years. We, and others, have continued to make larger firm and employee commitments to our funds, further incentivizing our employees to do well for our investors.

With the addition of new technologies and important groups like the Institutional Limited Partners Association, there is also a focus on making sure LPs have greater visibility into the underlying details of the companies in which they are invested. This enhanced transparency is not limited to the PE industry alone, and our world is better off for it. Information is at our fingertips. This is a good thing and promotes efficiency, integrity, and accountability. In my opinion, these are the mainstays to being a trusted partner in private equity, not just to LPs but to all of our stakeholders.

Today, success in PE involves many more facets and many more faces related to a deal. Our constituents include our limited partners and their beneficiaries but also the employees of our portfolio companies, stockholders, regulators and government officials as well as the media. As the collection of stakeholders has evolved quite significantly, so has the industry's approach to engaging with them.

To succeed in PE, communication and transparency are key. As we work to build strong relationships with our stakeholders, we remember: people do business with people they like and trust.

As far as the mainstays to being a good investor? I'd say curiosity and a sense of history. To me, people who are curious are going to be far better stewards of others' money. Why? If there's no curiosity, you're basically doing something that's already been done by someone else. Moreover, being knowledgeable of the past means you can learn from past mistakes and, hopefully, not repeat them. Without these two attributes, one will miss out on opportunities, or experience slip-ups, by not seeing the whole picture.

Now I know this has been a long answer to what is private equity? In my mind, at the forefront of this lengthy explanation has been one of my favorite quotes from General Eric Shinseki: "If you don't like change, you will like irrelevance even less." The industry has gone through many changes, but by doing so, private equity continues to attract some of the most sophisticated investors in the world.

While we will have to wait and see how the asset class continues to evolve, I anticipate that private equity of the future will need to prioritize diversity to remain germane.

Too many of the same people means too much of the same thinking—an element of today's industry that I feel greatly needs to be addressed. As we discussed earlier, more of the same is a stepping stone to irrelevance. We need to value having more diverse groups of people—diversity of gender, race and ethnicity, and especially diversity of experiences and thinking. There is no doubt that diverse groups drive better outcomes—it has been proven time and again—it creates a better work environment, more creative ideas and is a critical focus area of our investors. I think this is a lesson we are in the middle of and hope the industry will heed this important message in order to succeed in the future.

So what is private equity?

You will hear many answers to this question from industry leaders in the chapters ahead, but what I hope I've made clear is that private equity is so much more than its literal definition. For me, private equity always has been and always will be about building value over the long-term.

PREFACE

Gone are the days when "being in PE"[1] meant buying assets with steady cash flows in heavily leveraged transactions and riding the investments out to a successful exit. Despite the evolution, growth and increasing diversity of PE, this dated image persists, but no longer does the industry justice.

So, what does modern PE look like? The main difference from the activities of the '70s and '80s is that PE firms have developed into transformation agents that impact businesses at critical junctures of their development. PE funds are no longer just hands-off financial investors seeking to profit through changes to the capital structure or by selling off parts of a business; as the industry has matured, PE firms increasingly engage via active ownership to drive value creation in their portfolio companies. Indeed, a partnership with PE can provide portfolio companies with the edge to remain relevant in the hypercompetitive age of globalized markets.

Although PE has become synonymous with exceptional growth and wealth generation, the industry has endured its share of challenges. In particular, each financial crisis has opened the door to controversy. The spotlight focused on the performance of leveraged buyouts in times of highly visible defaults and then switched to venture investors' ambitious start-up valuations when valuations slipped and follow-on transactions took on a distinct pass-the-parcel flavour. There are ongoing debates about the fairness of profit-sharing between limited partners and general partners (and taxation of the latter) as well as the industry's impact on its investee companies and on the economy at large.

Will the value-added focus of the PE industry become a model for the financial markets of tomorrow? Will the limited partnership model itself require dramatic changes to survive? How can we better communicate the benefits professional PE can bring to companies and not only to investors? These are some of the relevant questions being asked by senior industry players as we set out to write this book.

As PE works its way into the economies of the 21st century, board members, senior executives, finance professionals and entrepreneurs are well advised to follow the industry's development carefully. After all, whether venture funds, super angels, growth equity funds, turnaround investors or buyout funds, we are talking about gatekeepers and agents who are entrusted with the capital of their investors to find the best entrepreneurial opportunities possible, whether in developed, emerging or frontier markets.

As for students of the industry and junior PE professionals, developing a solid understanding of the overall business model of PE will enable them to develop new ways to differentiate their firms in the eyes of investors. Attractive target companies in search of funding can choose from more than 8,000 professional PE firms worldwide to find those who meet their expectations and can deliver worthwhile partnerships.

1. In the context of this book, PE is defined broadly and includes venture capital (VC), growth equity and buyout funds. More about this later in the book.

A NOTE FROM CLAUDIA ZEISBERGER

As a professor at INSEAD, one of the leading global business schools, I am fortunate to be part of a diverse, young, dynamic and entrepreneurial community. As the academic director of the school's Global Private Equity Initiative, I am often the first port of call for students, alumni, senior executives and entrepreneurs for a multitude of PE related issues, including career transitions, start-up ideas, fundraising and access to industry professionals.

For years I have been asked for a resource that would enable them to deepen their knowledge on a specific topic of PE or VC. Every class has a group of students keen to dive deeper into a variety of niche topics that cannot be addressed within the time constraints of an MBA course. To satisfy those questions and to complement my classes, I started to write "Private Equity Primers"—short, concise class notes that focused on topics that deserved more detailed coverage.

The book you are about to explore started as a collection of those primers, often written in response to conversations with industry players at conferences to shed light on areas of PE that are, by their nature, not easy to understand. The notes have been fine-tuned over many years of class use.

Supporting this book with a selection of INSEAD case studies (published in *Private Equity in Action—Case Studies from Developed and Emerging Markets*) was an easy decision. They add context to the theoretical concepts, and allow the reader to consider the potential conflicts, controversies and challenges those PE funds face when deploying capital to deserving firms in both developed and emerging markets.

News coverage of the PE industry, often embellished for dramatic effect, does a good job of fueling the imagination of anyone from laymen to seasoned financial professionals. PE, with its wide variety of colorful characters and at times unconventional strategies, is often portrayed as the boogeyman of the financial services industry—deservedly or not—depending on whom you ask. To my frustration, much of the criticism of these private investment vehicles shows a lack of understanding of the basic principles of PE and VC. Admittedly, this is a function of a traditionally opaque industry that could have done a much better job of educating the broader public on the mechanics of and benefits behind its investment activities.

This book aims to create clarity, increase the level of understanding of PE and help interested professionals not only to connect the dots, but also to support them in the process of executing that first deal, whether as a PE professional or as a board member courting the first external investor.

Two INSEAD alumni join me as co-authors for this book. Over the years, we have collaborated on various research projects at INSEAD's PE center and, through their work in the alternative investing space globally, they add another perspective to the industry.

Asking senior professionals in our network to add their thoughts to each chapter in brief guest comments and also to review our writing, was a natural extension of this principle of marrying academic rigor with the real-life challenges facing PE professionals. Our guest authors provide a candid counterpoint to our arm's length discussion and raise critical points.

The authors' views and biases of course play into the reflections; they shape the lens through which we view the world. In my case, more than 20 years in the now fully emerged markets of Asia have certainly given me a vantage point away from the standard western PE model. I have had the opportunity to observe PE firms professionalize and improve young businesses, revamp their operations and allow them to launch into an accelerated growth phase, despite owning a minority equity stake. Overall I have seen PE effect real change in the fast-growing markets of Asia and Latin America. My co-authors balance this out through their experience.

Writing this book was a fascinating journey that brought several points to light:

- PE and VC, while popular topics, are rarely, if ever, examined in the context of the broader economy.
- Industry players are often frustrated by the lack of understanding of their craft within the business community, which leads to misinterpretation and misrepresentation and at times to a backlash or unfair accusations.
- Research papers—both of the applied and academic kind—more often than not take a closer look at narrow and specific areas of PE, thereby ignoring the contextual issues. Resources to help one understand the big picture, covering the spectrum from venture to growth equity to buyouts, are few and far between.

There was room for a book to step in and fill some of the gaps to prepare all parties for an informed discussion.

HOW TO USE THIS BOOK

This book was written with a professional audience in mind and carefully structured to accommodate both graduate students and experienced professionals. It makes a solid attempt at reflecting on its central themes without judgment, by relating the facts and ensuring that readers are well prepared to participate in an intelligent discussion about the pros and cons of private equity (PE).

Used together with the case book *Private Equity in Action—Case Studies from Developed and Emerging Markets*, which complements the text, this book brings the learning points to life and offers readers a ringside seat to the day-to-day challenges facing partners in PE and venture funds.

- For novices to the field of PE, our book provides clear insights into the workings of the industry. While the book assumes a sound understanding of basic finance, accounting techniques and risk–return concepts, it offers links to literature and research to ensure clarity for those rusty in the theoretical concepts behind today's financial markets.
- Graduate and postgraduate students will find the book an invaluable companion for their PE, venture capital and entrepreneurship courses; it will allow them to connect the dots and ensure that an understanding of the dynamics in the industry is maintained as they explore the respective chapters in greater detail.
- For seasoned financial professionals, the book includes guest comments from industry experts and links to advanced literature that provides a nuanced view of the industry and will allow them to engage with other professionals, be they lawyers, bankers, consultants or partners of PE firms, in a meaningful way.

Ensuring that our readers develop a sound understanding of PE before diving into more controversial aspects of the industry was a clear goal from the outset; it defined the flow and the logic of the chapters. The book's structure allows the expert reader to use the book as a quick reference with easily retrievable highlights of the best practices employed in the industry; it also allows observers of the industry and students to work through the topics step by step and take advantage of the many resources and cross-references to other finance topics.

Overall the chapters are grouped into five sections:

SECTION I offers a high-level introduction to PE to ensure that we speak the same language and use appropriate industry terms and definitions throughout the book. It puts venture capital, growth equity and leveraged buyouts into context and describes several alternative PE investment strategies such as distressed investing and real estate.

SECTION II looks in greater detail at PE investment processes, starting with deal sourcing, due diligence and target valuation before exploring deal pricing considerations and the actual structuring of PE deals. It also includes a thorough coverage of transaction documentation.

SECTION III asks: What do PE and venture funds do with their portfolio companies during the holding period? How will they transform these businesses and prepare them for exit?

SECTION IV describes the key dynamics involved in raising a PE fund. We step into the shoes of global institutional investors in PE to examine their demands with regard to reporting and portfolio customization.

SECTION V builds on the understanding gained in the previous chapters and takes a closer look at recent developments in the industry, from direct and co-investment programs to the fast-growing secondaries markets and the recent rise of listed PE funds. In the closing chapter the authors comment on the industry's development and explore key themes that will shape private equity and venture capital in the years ahead.

Additional material to complement this book and connect it to the case book *Private Equity in Action—Case Studies from Developed and Emerging Markets* can be found on the companion website:

www.masteringprivateequity.com

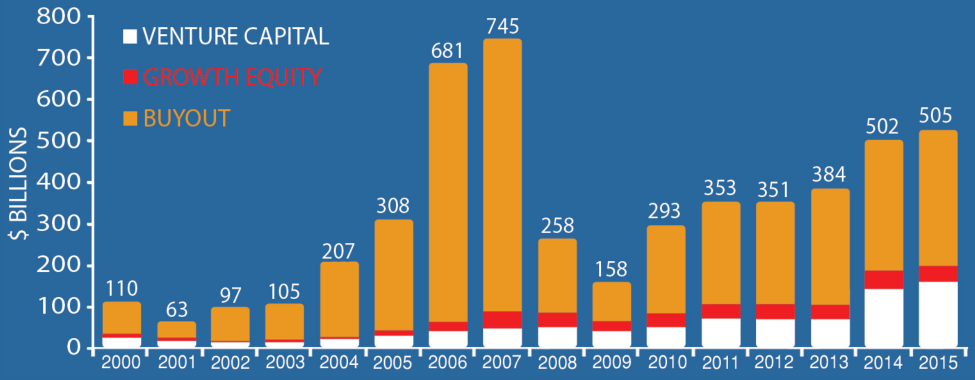
SECTION I

Private Equity Overview

The first section of the book provides readers with a high-level introduction to the institutional private equity (PE) market—from early-stage venture capital to growth equity and buyouts, plus a brief description of several alternative PE strategies. While buyouts have historically accounted for the vast majority of global PE capital deployed,[1] venture capital and growth equity investment activity has steadily increased as the industry matured over the past decades (see Exhibit A).

Section I is by far the least technical part of this book, intended to familiarize newcomers with the asset class and the concept of investing institutional capital in private companies in return for equity stakes. While crucial for readers new to PE, professionals familiar with the industry may choose to move directly to later sections of the book.

Exhibit A: Total PE Industry Capital Deployed by Strategy



Source: Preqin

1. Buyouts have accounted for more than three-quarters of industry capital deployed between 1980 and 2015. Source: Preqin.

Section Overview

Chapter 1. Private Equity Essentials: This chapter defines the traditional limited partnership fund model, specifically the players involved, a fund's investment lifecycle, and typical fund economics and fee structures. To be clear, our work refers to the organized PE market, i.e., professionally-managed equity investments by specialized intermediaries (PE firms) and their institutional backers; it excludes other forms of "informal" private capital investments.

Chapter 2. Venture Capital: Venture capital (VC) generally flows into early-stage companies—start-ups—that offer high risk/high return investment opportunities. We introduce the different types of venture investors (business angels, start-up incubators and accelerators, VC funds, and corporate VCs) and explain the use of VC at different points in a company's development, from proof-of-concept to commercialization and scaling up. Both aspiring entrepreneurs as well as future venture investors will find this chapter useful.

Chapter 3. Growth Equity: Acquiring minority equity stakes in fast-growing companies is the focus of growth equity funds. Managing multiple stakeholders without a control position is a key challenge for these funds; establishing a productive working relationship with existing managers and owners is therefore a key determinant of success. This chapter is particularly relevant for readers interested in PE in emerging markets.

Chapter 4. Buyouts: Buyout funds acquire controlling equity stakes in mature and sometimes listed target companies, often employing ample amounts of debt in leveraged buyouts (LBOs). The skillset required to execute large LBOs and drive value post-investment differs from that needed for growth equity or VC: it requires both financial and process management skills, combined with the ability to create operational value in the portfolio firms.

Chapter 5. Alternative Strategies: In the final chapter of this section, we explore alternative PE strategies focused on investing in distressed businesses and real assets. The former requires unique skills to restructure and improve a company's operations (turnaround) or its balance sheet (distressed debt), while the latter describes a range of strategies (investing in real estate, infrastructure, and natural resources) that use a PE operating model and adapt it to distinct industry verticals.

PRIVATE EQUITY ESSENTIALS 1

At some point in their development, all companies will need either a helping hand or a shot in the arm. A fresh injection of capital or external managerial expertise is often necessary to help organizations overcome developmental challenges, realize their full potential and seize the opportunities that lie ahead. Start-ups hunt for the visionary capital that will enable them to turn a concept into a launched product. Mature companies are increasingly subject to market disruption, increased competition or pressure to update manufacturing processes and corporate governance structures. Companies that have been performing poorly for a prolonged period of time need to identify and then rectify the problems that confront them. Family businesses must honestly address succession planning ("it is only but three generations from shirtsleeves to shirtsleeves"[2]).

The needs and demands of businesses at such critical inflection points often exceed the capabilities and services provided by the established financial institutions and consulting firms. Capital markets, for instance, are unlikely to offer a solution for small and medium-sized enterprises (SMEs). Into this void steps private equity (PE) in the form of venture, growth, and buyout funds, at its best offering patient and long-term capital, dedicated expert advice and hands-on operational support.

In the last four decades PE has emerged as the transformation agent of choice for companies seeking change; at times, it is the only choice for a business in need of capital and a risk-sharing partner to facilitate future growth. The PE ecosystem has grown dramatically during that time; as of 2015 the industry (including its alternative strategies and co-investments) has over US$4.5 trillion in assets under management, of which US$2.3 trillion are deployed through core PE strategies. This capital is being invested and managed by over 8,000 professional funds globally. Understanding this industry—its drivers and its dynamics—is a must for entrepreneurs, owners of family businesses, board members of multinationals and senior managers.

So what exactly is PE? PE funds invest long-term capital in private (or, at times, public) companies in return for an equity stake that is not freely tradable on a public market.[3] Our definition of PE includes so-called "take-privates" (i.e., delistings of public companies) and private investment in public equity that come with specific governance rights. This book focuses strictly on the activity of professionally managed PE funds advised by highly specialized intermediaries (PE firms) and excludes "informal" private capital, such as investments made by business angels or families who typically draw on their own private wealth.

This first chapter gives our readers a high-level overview of PE funds, by defining their structure and the motivation of the key players involved. We then explain how PE funds go about their business, both from the general partner's (GP's) and limited partner's (LP's) perspective and shed light on the often complex economics and fee structures in PE.

2. Origin unknown but the quote is often attributed to Andrew Carnegie.

3. In our context, PE takes on a broad definition that includes VC, growth capital, and buyout funds. It should be mentioned that other sources might restrict the definition of PE to buyout activities and consider VC to be a separate asset class. Further, PE is frequently defined as investments in private companies but buyout activities extend to investments in and the privatization of public companies. For the sake of clarity, our definition of "private" equity refers to the status of the equity stake held by the PE fund post-investment.

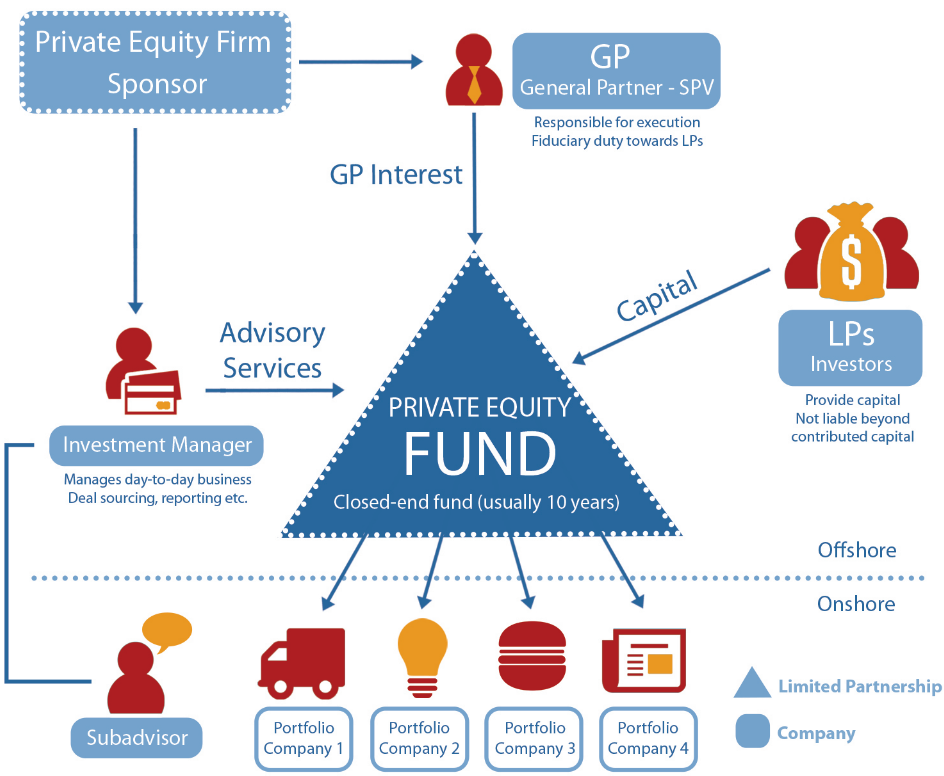
PRIVATE EQUITY FUNDS DEFINED

A PE fund is a stand-alone investment vehicle managed by a PE firm on behalf of a group of investors. The capital is raised with a clear mandate to acquire equity stakes in private companies and divest them over time.

Most PE funds globally are set up as closed-end limited partnerships and operate as "blind pool" vehicles. Closed-end funds have a finite lifespan and require investors to commit capital for the fund's entire term—typically 10 years—without early redemption (or withdrawal) rights.[4] While investors in a PE fund have a clear idea of its broad mandate (for example, mid-market European buyouts), they have no say in the choice of the individual companies that a fund will invest in, hence the term "blind pool." Certain jurisdictions use limited liability companies or corporate structures as the vehicle of choice for a PE fund, but they are the exception.

We will start with a closer look at the parties involved in a limited partnership PE fund structure, as shown in Exhibit 1.1.

Exhibit 1.1 Limited Partnership PE Fund Structure



4. The PE secondaries market can provide liquidity for an LP wishing to sell its interest in a PE fund. This market has developed rapidly over the last decade with dedicated funds raised for the express purpose of acquiring secondary fund stakes. See Chapter 24 Private Equity Secondaries for more information.

PE FIRM: A PE firm is a company with expertise in executing a venture, growth or buyout investment strategy. It raises and advises a fund—and, if successful, over time a family of funds—generally through two separate yet affiliated legal entities: the GP and the investment manager. Members of a PE firm typically hold all the key directorships and other decision-making positions of both the GP and the investment manager for every fund raised by the firm. Establishing these separate legal entities insulates the PE firm from liabilities related to and its principals from any claims on the PE fund. Examples of notable PE firms are buyout firms Kohlberg Kravis Roberts (KKR) and APAX Partners as well as venture firms Sequoia Capital and Kleiner Perkins Caufield Byers.

LIMITED PARTNERS: Investors or LPs contribute by far the largest share of capital to any PE fund raised. LPs participate merely as passive investors, with an individual LP's liability limited to the capital committed to the fund. Investors active in PE include private and public pension funds, endowments, insurance companies, banks, corporations, family offices, and fund of funds.[5] LPs are purely financial investors and cannot be involved in the day-to-day operation or management of the fund or its investee companies without running the risk of forfeiting their limited liability rights. LPs legally commit to provide capital for investment when it is drawn down (or "called") by the PE fund and they receive distributions of capital—including a share of profits—upon successful exit of the fund's investments.

GENERAL PARTNER: A fund's GP is wholly responsible for all aspects related to managing the fund and has a fiduciary duty to act solely in the interest of the fund's investors. It will issue capital calls to LPs and make all investment and divestment decisions for the fund in line with the mandate set out in its Limited Partnership Agreement (LPA). The GP may delegate some of the management functions to the investment manager or a PE firm's investment committee (IC),[6] but remains fully and personally liable for all debts and liabilities of the fund and is contractually obligated to invest the fund's capital in line with its mandate.[7] A GP—and in turn a PE firm's partners and senior professionals—will also commit capital to the fund to align its interest with that of the fund's LPs by ensuring that the firm's partners have "skin in the game"; the GP stake typically ranges from 1 to 5% and rarely exceeds 10% of a fund's total capital raised.

INVESTMENT MANAGER: In practice, the investment manager[8] conducts the day-to-day activities of a PE fund; it evaluates potential investment opportunities, provides advisory services to the fund's portfolio companies, and manages the fund's audit and reporting processes. The manager is paid a management fee by the fund for providing these services, some of which may be passed on to a subadvisor. The management fee is typically set at around 1.5–2% of committed capital during the investment period of the fund; after the end of the investment period, it is calculated

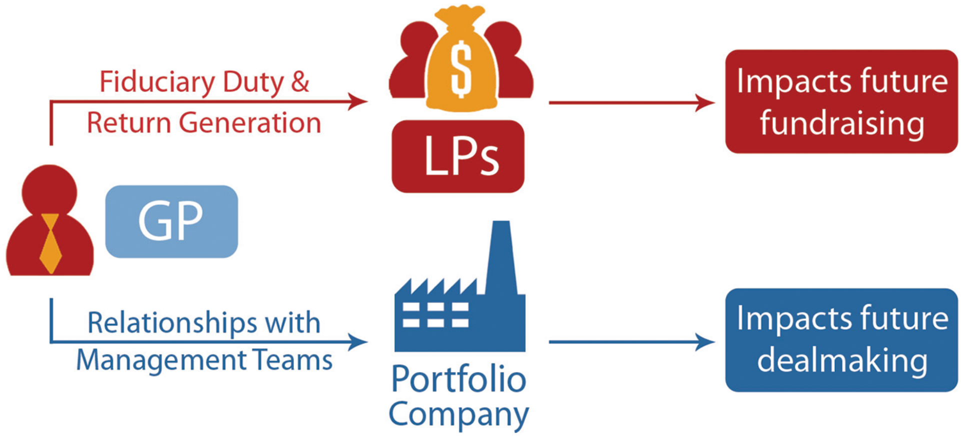
5. A fund of PE funds (fund of funds) is a vehicle that invests in a portfolio of individual investment funds. A fund of funds offers clients diversified exposure to the PE asset class without the need for deep investment expertise or lengthy due diligence on the individual funds. An additional layer of fees applies.

6. The IC is typically a committee of the GP and makes the binding investment and divestment decisions for the fund under delegated authority from the GP ("binding" in the sense that once the IC votes, there is no other vote needed or taken).

7. GPs are usually set up as distinct special purpose vehicles (SPVs) for each fund; these SPVs serve as the GP for only one fund to avoid cross-liabilities between related funds of the PE firm. Please refer to Chapter 16 for further details on fund formation.

8. Investment managers will also be referred to as advisors or simply managers.

Exhibit 1.2 Key Relationships GPs Must Manage



on invested capital and may step down to a lower rate. More information on fee structures can be found later in this chapter.

PORTFOLIO COMPANY: Over its lifecycle, a PE fund will invest in a limited number of companies, 10–15 on average, which represent its investment portfolio. These companies are also referred to as investee companies or (during the due diligence process) as target companies. A PE firm's ability to sell its stakes in these companies at a profit after a three- to seven-year holding period will determine the success or failure of the fund.

From the perspective of the PE firm and its affiliated entities, the business of PE comes down to two simple yet distinct relationships: on the one hand, the firm's fiduciary duty towards its LPs and on the other hand its engagement with entrepreneurs, business owners and management teams in its portfolio companies (Exhibit 1.2). Establishing a reputation of professional conduct and value-add will ensure access to both future fundraising and investment opportunities.

THE GP PERSPECTIVE
LIFECYCLE OF A PE FUND

A traditional PE firm's business model relies on success in both raising funds and meeting its target return by effectively deploying and harvesting fund capital. PE funds structured as limited partnerships are typically raised for a 10-year term plus two one-year extensions, commonly referred to as the "10+2" model. Generally speaking, a GP will deploy capital during the first four to five years of a fund's life and harvest capital during the remaining years. The two optional years allow the GP to extend a fund's lifespan at its discretion if and when additional time is needed to prudently exit all investments.

Exhibit 1.3 shows the overlapping timelines for the fundraising, investment, holding, and divestment periods of a closed-end fund.

Exhibit 1.3 Lifecycle of a PE Fund

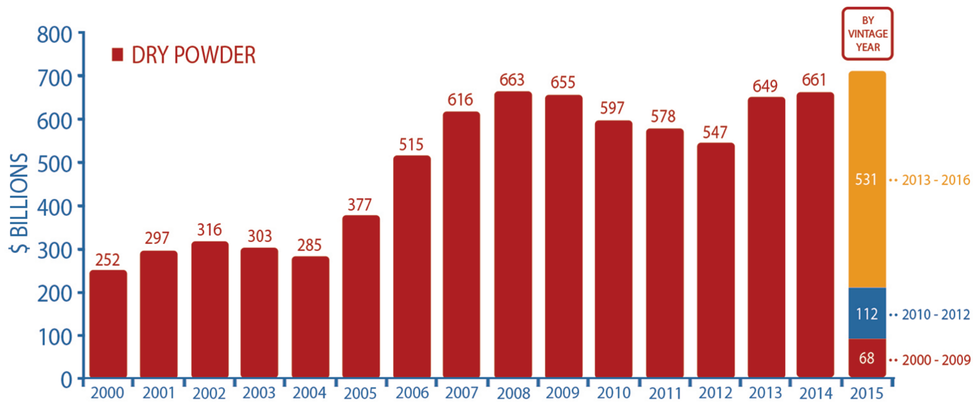
FUNDRAISING: PE firms raise capital for a fund by securing capital commitments from investors (LPs) through a series of fund closings.[9] A PE firm will establish a target fund size from the outset—at times defining a "hard cap" to limit the total amount raised in case of excess investor demand. Once an initial threshold of capital commitments has been reached, the fund's GP will hold a first closing, at which time an initial group of LPs will subscribe to the fund and the GP can start to deploy capital. A fund holding its first closing in 2016 is referred to as a "vintage 2016 fund," a fund with a first closing in 2017 will be known as a "vintage 2017 fund," and so on. Fundraising will typically continue for a defined period—12 to 18 months—from the date of the first closing until the fund reaches its target fund size and a "final closing" is held. The total amount raised by a PE firm is known as a fund's committed capital.

INVESTMENT PERIOD: Rather than receiving the committed capital on day one, a GP draws down LP commitments over the course of a fund's investment period. The length of the investment period is defined in a fund's governing documents and typically lasts four to five years from the date of its first closing; a GP may at times extend the investment period by a year or two, with approval from its LPs. Once the investment period expires, the fund can no longer invest in new companies; however, follow-on investments in existing portfolio companies or add-on acquisitions are permitted throughout the holding period. A fund's LPA may also permit its GP to finance new investments from a portion of fund realizations within a certain limited period after divestment (this is known as the recycling of capital), thus increasing a fund's total investable capital.

GPs draw down investor capital by making "capital calls" to fund suitable investment opportunities or to pay fund fees and expenses. LPs must meet capital calls within a short period, typically 10 business days. If an LP fails to meet a capital call, various remedies are available to the GP. These include the right to charge high interest rates on late payments, the right to force a sale of the defaulting LP's interest on the secondaries[10] market and the right to continue to charge losses and expenses to the

9. Please refer to Chapter 17 for more details on the fundraising process and its dynamics.
10. Please refer to Chapter 24 Private Equity Secondaries for further details on the mechanics behind the transfer of such LP stakes.

Exhibit 1.4 PE Industry Dry Powder



Source: Preqin

defaulting LP while cutting off their interest in future fund profits. The portion of LPs' committed capital that has been called and invested is referred to as contributed capital. A fund's uninvested committed capital is referred to as its "dry powder"; by extension, the total amount of uninvested committed capital across the industry is referred to as the industry's "dry powder." Exhibit 1.4 shows the increase of the industry's dry powder since 2000; the 2015 data adds perspective on its origin by grouping dry powder according to vintage year.[11]

HOLDING PERIOD: Holding periods for individual portfolio companies typically range from three to seven years following investment, but may be significantly shorter in the case of successful companies or longer in the case of under-performing firms. During this time, a fund's GP works closely with portfolio companies' management teams to create value and prepare the company for exit.[12]

DIVESTMENT PERIOD: A key measure of success in PE is a GP's ability to exit its investments profitably and within a fund's term; as a result, exit strategies form an important part of the investment rationale from the start.[13] Following a full or partial exit, invested capital and profits are distributed to a fund's LPs and its GP. With the exception of a few well-defined reinvestment provisions,[14] proceeds from exits are not available for reinvestment. When a fund remains invested in a company at the end of a fund's life, the GP has the option to extend the fund's term by one or two years to avoid a forced liquidation.[15]

11. Dry powder in Exhibit 1.4 is for venture, growth and buyout investment strategies. Source: Preqin.
12. Please refer to Chapter 13 Operational Value Creation for more background.
13. Please refer to Chapter 15 for a detailed description of exit considerations and the related processes.
14. The capital invested in a deal and returned without any profits achieved, may be reinvested under the following conditions: (a) a so-called "quick flip" where an exit was achieved within 13–18 months of investing during the investment period; or (b) to match the amount of capital drawn down to pay fees, with the target to put 100% of the fund's committed capital to work. These rules are defined in a "remaining dry powder" test.
15. Please refer to Chapter 20 Winding Down a Fund for additional information on end-of-fund life options.