HIGHTOWER
Bethesda

Private Equity

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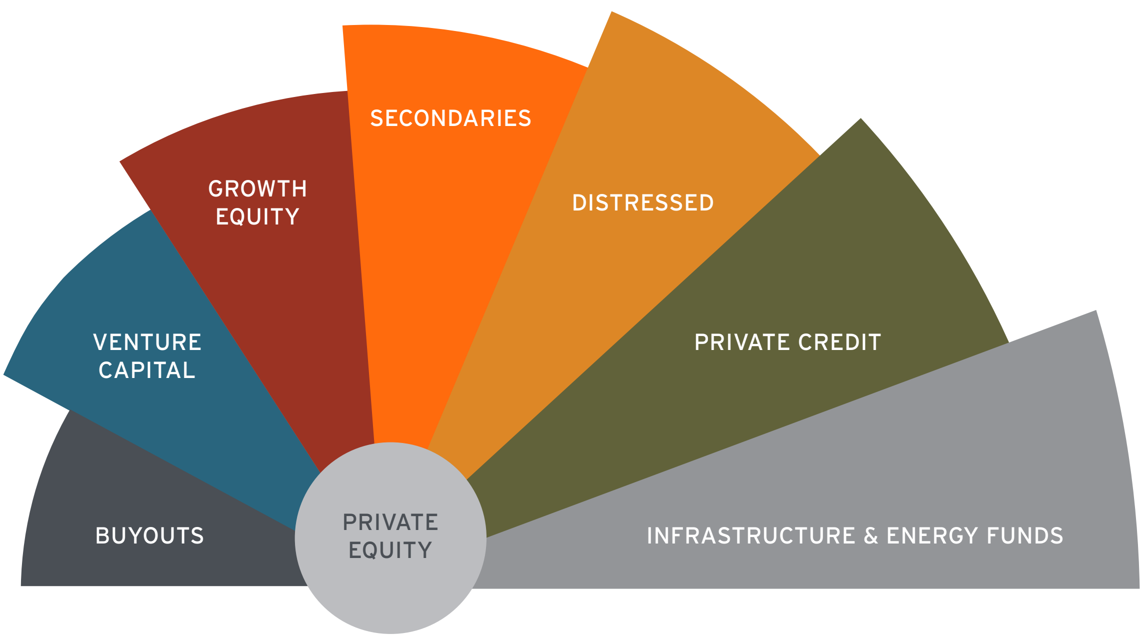
An Alternative Approach to Investing

Over the past 20 years, the number of public companies listed on the NYSE and NASDAQ dropped from a peak of around 8,000 to between 5,000 and 6,000 today (JP Morgan Insights, May 2019). The shift is toward more companies staying private. Reasons for opting to remain a private company include: avoiding heavily regulated public markets, which allows the company to focus on long-term growth versus short-term quarterly calls; better terms and more options for raising equity and debt in private markets, and the ability for owners to maintain control.

Types of Investments



Private equity is an all-encompassing term to describe investment in a company not listed on a public exchange. Common categories include:

- **Buyouts** - At its most basic definition, a buyout fund pursues a controlling or majority ownership of a target portfolio company. The General Partners (GPs) could target a private company for purchase or seek to take a public company private.
  The two major subcategories are:
  - Leveraged Buyout (LBO) – LBOs use mostly debt capital to finance the acquisition of their targets, with financing being provided by banks or private credit funds
  - Middle Market Buyout - Target companies are smaller than those described above

Types of Investments (continued)

- **Venture Capital** – Venture capital investments are generally made in young and unproven companies, and can be made across many different industries. Venture capital can be further broken down into different risk and return profiles, from most risky to least risky these are:
  - Seed
  - Angel
  - Early stage
  - Late stage
  - Pre-IPO
- **Growth Equity** - An investment in private companies with established profitable businesses because the portfolio company may need capital for growth, or to acquire a competitor.
- **Secondaries** – Secondaries are the buying and selling of existing private equity funds. Secondaries provide liquidity to existing Limited Partners (LPs) who are seeking an exit prior to the end of the fund's committed term. From an entering LP's perspective, this type of investment can be used to gain access to a diversified pool of private equity funds that are already seasoned and can dampen the J-curve effect (described in greater detail later in this paper).
- **Distressed** - This investment is into a financially challenged company via its debt or equity.
- **Private Credit** - Since the global financial crisis, many traditional lenders have stepped out of this playing field, leaving a hole in providing financing to higher risk borrowers. The credit risk for each underlying investment requires careful due diligence and evaluation. Common categories within private credit lending include:
  - Senior secured lending
  - Mezzanine lending
- **Infrastructure and Energy Funds** - Specialization in infrastructure assets, such as toll roads, and telecommunications or energy assets, such as pipelines and refining facilities.

Structure

Typically, private equity investments are a limited partnership, where the General Partners (GPs) oversee the investment of the fund's assets and manage the day to day operations. LPs supply the capital and are considered a silent partner, seeking to benefit from the GPs skill.

Private equity funds are generally closed-end investment vehicles with a life of at least 10 years and often have up to (3) one-year extensions. The extension period provides the GPs with flexibility around the exit timing of investments. For context, consider being forced to exit an investment in 2008 during the height of the global financial crisis versus waiting until 2011 when the market had time to recover.

Limited Partnership Phases

COMMITMENT	INVESTMENT	HARVEST	DISTRIBUTION & EXIT
GPs raise capital from investors and LPs make capital commitments to the fund.	GPs start drawing on investor capital commitments to invest in private equity deals and implement their strategy	The focus now is on growing the companies and ultimately seeking to exit at a profit.	GPs have several options to exit their investments. They can take the company public via an Initial Public Offering (IPO), seek strategic buyers, or a management buyout (MBO) to name a few options.

COMMITMENT

Once LPs are invested there are different stages to the investment. The initial phase is known as the "commitment phase", where the GPs raise capital from investors and LPs make capital commitments to the fund. The funds raised during this time ultimately dictate how much the GPs will have available to invest.

INVESTMENT

At the same time the fund is collecting capital, they can also begin the "investment period", after the first close and having received its first round of capital commitments from LPs. Therefore, the fund can begin making investments overlapping with the commitment period. During the investment phase, the GPs call the LP's capital through a "capital call", which indicates the GPs have found a worthy investment and have agreed to the terms with a seller, and are now ready to fund their portion of the investment. These calls are generally a fraction of the overall commitment taking place, until the capital is fully called. The investment period generally happens over a period of one to three years, depending on how quickly attractive opportunities can be identified and terms negotiated.

HARVEST

Once all the capital has been called and deployed into underlying investments, the fund enters the "harvest phase", hoping to see results from the investments it has made early on. This phase often overlaps with the investment phase, in particular with the investments made early on. The focus now is on growing the fund's underlying companies and ultimately seeking to exit by selling the acquired companies at a profit. During this time, the GPs may exit early investments and reinvest the proceeds into new portfolio companies, or return capital to investors in the form of a distribution. All realized transactions made by the GPs are reported via a K1 which LPs use at the end of the year for individual tax purposes. Private equity investors only receive their capital back when the GPs decide to make a distribution.

DISTRIBUTIONS AND EXIT

The GPs may realize value through an exit and have several options to do so. The ultimate success of the exit will depend on the profitability and growth of the acquired company. All acquired companies do not result in a successful exit, defined as making money on the initial investment, but the ones that do can be very profitable, making up for the losing bets.

Options for exit:

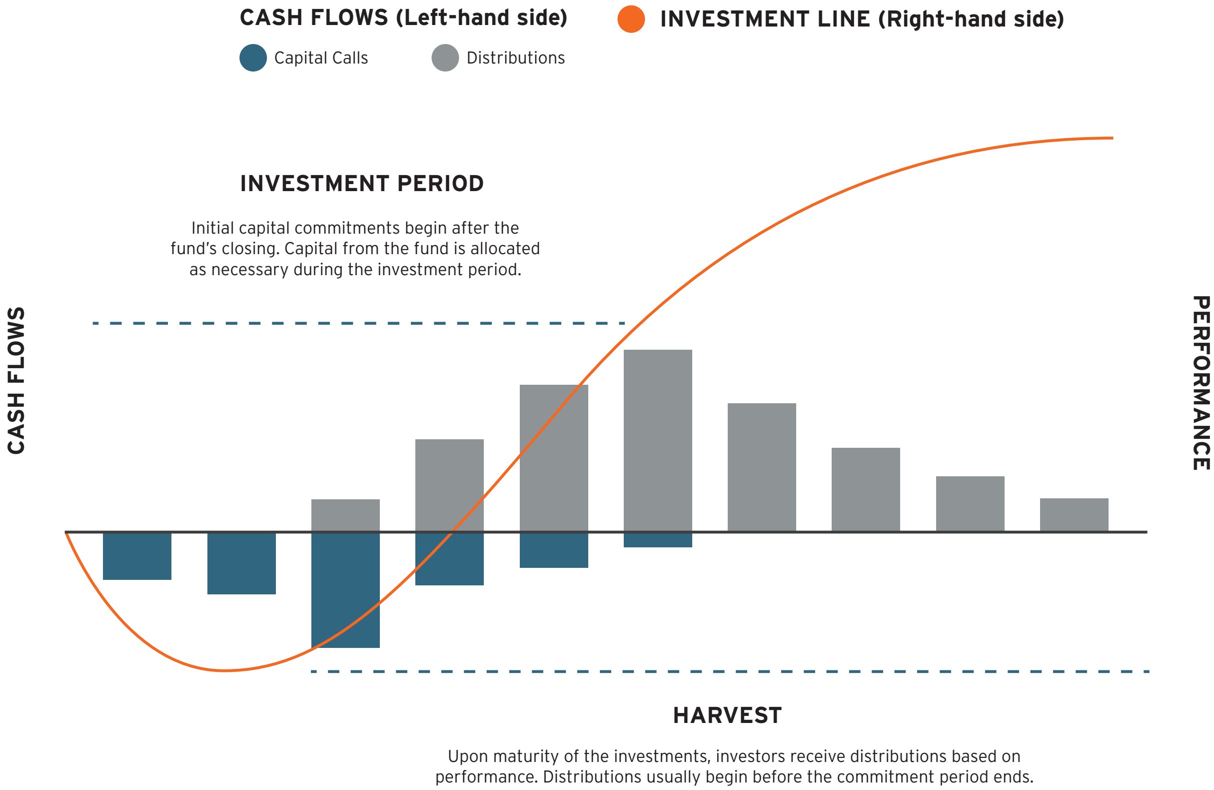
- Take the company public via an Initial Public Offering (IPO)
- Seek new strategic buyers who want to buy the private company
- The owners of the target firm may want to acquire a greater percentage of the company from the private equity manager through a management buyout (MBO)

J-Curve Effect

Investors will not have positive cash flows from the investment for several years; this is referred to as the J-curve. The J-Curve is generally a function of four things:

1. Capital calls in early years of the investment aren't generating a return immediately, as the acquired firm needs to use the investment made by the Private Equity firm to generate additional growth (distributions generally don't occur until the harvest phase begins).
2. Management fees are paid without seeing a return on investment; these fees can be charged on the entire committed capital, which hasn't yet been put to work.
3. Often, to be conservative, portfolio holdings are held at cost for an extended period of time.
4. Expenses associated by the acquisition transactions are borne by the fund up front, leading to a drag in performance early on.

Fig. 1 | The J-curve



References
4. Mercer. For illustrative and educational purposes only

The J-curve effect is mostly an unavoidable feature in the structure of private equity investments, and is accepted as part of the return experience by long-term investors in the asset class. Successful investors in private equity understand the need for patience with early reported returns that are not indicative of potential long-term success from the investments.

Considerations in Allocating to Private Equity

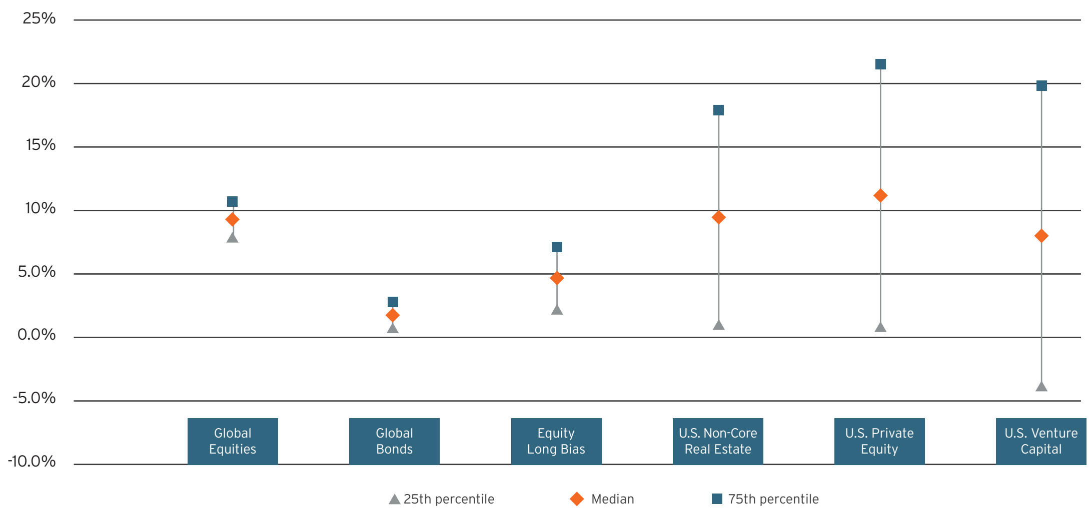
Diversification is still key among three areas:

- **Strategy** - As outlined previously, there are a variety of private equity funds (buy out, growth equity, distressed, venture). The timing involved in exposure to various strategies can be of particular importance during different times in the overall market cycle.
- **Vintage Year** - "Vintage" is classified either on the first year or on the final close for the commitment period. Given the long-term nature of market cycles which are typically characterized by different stages that impact performance, allocating to private equity over multiple years (vintages across five to 10 years) potentially mitigates risks due to market cycles.
- **Manager** - Active management is of particular importance when selecting a private equity manager; it is preferable to have exposure to top tier managers.

Importance of Manager Selection

The interquartile spread in private equity is far higher than in any other asset class, making informed manager selection paramount to successful investing.

Interquartile Spread by Asset Type



Sources: Lipper, NCREIF, Cambridge Associates, HFRI, J.P. Morgan Asset Management. Global equities (large cap) and global bonds dispersion are based on the world large stock and world bond categories, respectively. Manager dispersion is based on 2013 - 2018 annual returns for global equities, global bonds, U.S. core real estate and hedge funds. U.S. non-core real estate, U.S. private equity and U.S. venture capital are represented by the 5-year horizon internal rate of return (IRR). Data is as of December 31, 2018. Confidential | For Investment Professional and Qualified Investor Use Only.

*Past performance is no guarantee of future results

Noteworthy Risks of Private Equity

- Illiquidity
- Volatility in Private Markets
- Lack of Control

Evaluating Alternatives

What is important in evaluating alternatives to add to an individual's portfolio?

- Having a thorough and knowledgeable team that understands and can navigate investing in alternatives.
- Access to top-tier alternative investments.
- Lower and more attainable minimums for individual clients.
- Understanding how the investment is expected to perform over time and monitoring that performance.
- Understanding the fee structure.
- Understanding the illiquid and long term commitment to the investment.

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