Alternative Investments

Investments in Private Capital: Equity and Debt

Exam Focus

- Features of private equity and investment characteristics
- Features of private debt and investment characteristics
- Describe the diversification benefits that private capital can provide

Public and Private Capital

Public capital is funding to companies from **public markets**, such as from the sale of equities, bonds on exchanges, or from traditional providers of capital such as banks or the government.

Private capital is funding from **private markets**:

- **Private equity** includes venture capital, leveraged buyouts, and growth capital
- **Private debt** provided through private loans and other private debt

Capital: Question

The potential diversification benefits from private capital investment are *most likely* related to its:

A. wide range of exit strategies.

B. various types of fee structures.

C. lower correlation with public asset returns

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Source: CFA Institute. Used with permission.

Leveraged Buyout (LBO)

A **leveraged buyout (LBO)** refers to investors raising borrowed funds to acquire public companies to take them into private ownership:

- Leverage is a significant percentage of the purchase price
- Objective is to add value to the company
- Improve operations, boost revenue, and increase profits and cash flows
- Reduce costs, restructuring, acquisitions, and spinoffs

Management buyout (MBO): current management team leads the acquisition

Management buy-in (MBI): new management team replaces existing management aiming to turn around the business

Private Equity Investment Categories

Venture capital refers to investing in start-ups or young companies at various stages of their development:

- Pre-seed: founders, family, friends, and angel investors; $5k–$500k
  - **Idea stage**, develop a business plan, assess market potential
- Seed: seed funds and angel investors: $25k–$5 million
  - **Product development** and market research
- Early stage: venture capital funds, private equity investors; >$5 million
  - **Developing operations**, but before commercial production
- Later stage: venture capital funds, private equity investors; >$5 million
  - **After commercial production**, sales have begun, supporting expansion

Mezzanine Finance

Later-stage financing is provided through a mix of **equity** and **debt** as portfolio company continues to grow and expand

- Debt financing provides more security to VC investors

Mezzanine-stage financing a.k.a. mezzanine venture capital

- Bridge financing for a late-stage venture firm growing rapidly, heading for an IPO
- **Mezzanine-stage financing** is distinguished by timing of the financing
- **Mezzanine financing** relates to the use of equity-debt hybrid instruments
  - *Convertible preference shares* have additional protection in a liquidation
  - Entitled to recover the value of their investment before common shareholders

Venture Capital: Question

Which of the following financing tools would *most likely* be used at the later stage of venture capital investment?

A. Common stock.

B. Preferred stock.

C. Convertible debt.

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Private Equity

Private equity firms: take over from venture capital firms in the **later stage** of a successful new venture

- Increase the value of the core business
- Directly influencing management to implement strategy changes
- Eliminate poor-performing business lines, selling underperforming assets

Minority interests a.k.a. **growth equity** or **growth capital**

- Management's motive is to sell a portion of shares, but retain control
- New investors provide the capital needed to expand and enter new markets

Private Investment in Public Equity (PIPE)

Private investments in public equities (PIPEs): offered to **select investors** with fewer disclosures and lower transaction costs

- Allows the issuer to raise capital quickly and cost effectively
- Investors receive either newly issued common stock or existing shares
- Typically for institutional investors who agree to purchase shares at a fixed price
- Common in **workout** or **rescue situations**

Convertible debt or convertible preference stock

- A special case of PIPE is capital raised through equity-debt hybrid instruments
- PIPE transactions **are dilutive** to existing shareholders

Private Equity Exit Strategies

Private equity firms: improve new or underperforming businesses and plan to exit them at **higher valuations**

- Holding period can range from 6 months to more than 10 years
- Average holding period is 5 years, followed by a subsequent **harvesting period**

Exit strategy considerations

- Company performance, industry dynamics, economic cycle, and interest rates

Main exit strategies

- Trade sale and public listing

Private Capital: Question

Match each form of private capital investment with the combination of corporate life cycle characteristics most appropriate for it.

Investment Form	Corporate Life Cycle Characteristics
Private equity	Negative cash flow, high business risk
Venture capital	Increasing cash flow, high business risk
Both private equity and venture capital	Declining cash flow, increasing business risk

Trade Sale

Trade sale: involves selling a portion or division of a private company to a strategic buyer or via an auction

- **Strategic buyers** are interested in increasing scale or scope of an existing business and may be willing to pay a premium price
- **Fast** and **simple** transactions, with lower transaction costs
- **Higher confidentiality**, less external scrutiny

Disadvantages of a trade sale

- Resistance from existing management: **concerns over job security**, prefer IPO
- Universe of **trade buyers may be limited**, may raise regulatory scrutiny

Public Listing

A public listing on an exchange can be via an initial public offering (IPO), a direct listing, or a special purpose acquisition company (SPAC).

Initial public offerings arrange the sale of the private shares of the company to public investors:

- **Advantages:** realize a higher price, increase visibility, management support
- **Disadvantages:** high transaction fees to investment banks and lawyers, long time to complete, onerous disclosures, stock market volatility

In a direct listing, equity is floated without underwriters; there are lower costs and complexities.

Special Purpose Acquisition Company (SPAC)

A special purpose acquisition company (SPAC) exists to acquire **unspecified private companies** within a predetermined period to take public via an IPO:

- **"Blank check"** company as the investors don't know the IPOs in advance
- Must acquire companies within the specified period or return capital

SPAC advantages

- More time for public disclosures on company prospects to build investor interest
- Flexibility of transaction structure to suit each individual company
- Valuation of the entity is fixed in advance, reducing volatility and uncertainty

Special Purpose Acquisition Company (SPAC)

SPAC disadvantages

- **Increased cost of capital:** as many instruments used are dilutive (e.g., warrants)
- **Valuation spread:** between the SPAC equity and the equity bought by the SPAC
- **Deal risk:** in the execution of the purchase and merger agreement
- **Regulatory risks:** regulators are considering increased requirements

Stockholder overhang

- Occurs when large blocks of shares are sold on the open market
- Affects SPACs in the months after a purchase transaction is announced

Other Exit Strategies

A recapitalization raises debt capital to **extract money** from company to pay to investors

- It allows the private equity firm to retain control
- Not a true exit strategy

A secondary sale to another private equity firm, or group of financial buyers

- This exit strategy has increased in recent years

Write-off and liquidation if the investment is likely to lose value

- Liquidate the portfolio and move on to other projects

Risk-Return From Private Equity Investments

Private equity funds: provide **higher return opportunities** relative to traditional investments, but they have **higher risks**

- Ability to invest in private companies
- Influence on company management and operations

Risks

- Will the new venture or turnaround be successful?
- 7–10 years of investment, illiquidity, and leverage risks
- **Unreliable data:** self-reporting, survivorship and backfill bias, smoothed volatility, and understated correlations

Private Debt Categories

Private debt is primarily in four categories: direct lending, mezzanine loans, venture debt, and distressed debt

- **Direct investment:** investor makes a direct loan to an operating company
- **Indirect investment:** investor buys an interest in a fund that buys the debt of operating companies
- Investors receive interest payments and the return of principal after a term

Characteristics of the debt

- The debt is typically secured
- Covenants are used in the contracts to increase the protection for investors

Venture Debt

Venture debt is debt capital to start-up or early-stage companies

- Entrepreneur **retains ownership stake** as no shares are issued
- **Little or negative cash flow** to repay the debt
- May provide **valuable rights** to purchase equity in the new venture
- Investors receive interest payments and the return of principal after a term

Characteristics of the debt

- Similar to mezzanine finance, but the loans are to earlier-stage companies
- Complements existing equity financing

Direct Lending

Direct lending provides capital directly to borrowers

- Debt is typically **senior** and **secured**
- Payments are made on a **fixed schedule**
- Provided by a **small number** of investors

Private debt funds provide debt at higher interest rates

- Due diligence is essential for all forms of private lending

Leveraged loans are loans made from **borrowed funds**

- Private debt firms borrow money, then extend it to another borrower

Other Forms of Debt

Mezzanine debt is **subordinated** to senior secured debt, but senior to equity in the borrower's capital structure

- Often used to finance LBOs, recapitalizations, and corporate acquisitions
- Is usually **unsecured debt**
- Due to the higher risk, investors require **higher interest rates**
- May require **equity participation** (e.g., warrants or conversion rights)

Distressed debt: buying the debt of mature companies in financial difficulty

- May be in bankruptcy, have defaulted on debt, or have a temporary cash problem
- **Turnaround investors** aim to actively restructure and revive the company

Other Forms of Debt

Unitranche debt has a hybrid or **blended loan structure**:

- Combines different tranches of secured and unsecured debt into a single loan
- The **single loan** has a single blended interest rate
- The unitranche loan will have a priority ranking **between senior and subordinated**

Specialty loans are extended to niche borrowers in specific situations:

- **Litigation finance** provides debt to plaintiffs in litigation for legal fees and expenses in exchange for a share of judgments

Risk-Return of Private Debt

Private debt: may provide **higher-yielding opportunities** to fixed-income investors relative to traditional bonds

- Private lending filled the financing gap left by traditional banks after the 2008 financial crisis
- Earn illiquidity premiums
- Increased portfolio diversification

Specialized knowledge is required

- To profit from the **higher risks** and **higher returns**
- Of the underlying assets, especially for secured lending

Diversification Benefits of Private Capital

Performance and risks of private capital

- Depend on the phase of the company's life cycle, performance, and risk
- **Start-up** vs. **well-established firm**
- **Growth** vs. **declining industry**

Vintage year: the year in which a fund makes its first investment

- Typically, a private equity fund invests over 10–12 years
- An **investment period** followed by a **harvesting period**
- Business and valuation environments change (e.g., economic recovery/downturn)
- **Vintage diversification:** invest across multiple vintage years

Private Debt: Question

Identify the following statement as true or false: Modeling private debt returns is fairly straightforward because they are a function of a benchmark public debt return.

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Private Capital: Question

Match the form of private capital investment with its most likely position on the risk/return continuum:

Investment Form	Risk/Return Combination
Mezzanine financing	Lowest risk and return
Private equity	Intermediate risk and return
Senior direct lending	Highest risk and return

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Solutions

Capital: Question

The potential diversification benefits from private capital investment are *most likely* related to its:

A. wide range of exit strategies.

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Investments in private capital funds can add a moderate diversification benefit to a portfolio of publicly traded stocks and bonds. Correlations with public market indices vary from 0.63 to 0.83.

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Venture Capital: Question

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Preferred stock can be deployed as late into a company's maturity as later-stage venture capital, when preferred stock can offer more protection to venture investors as a company transitions toward an IPO. A and C are incorrect because these instruments are more typically used in the earlier pre-seed and seed stages.

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Private Debt: Question

Identify the following statement as true or false: Modeling private debt returns is fairly straightforward because they are a function of a benchmark public debt return.

False. While private debt and public debt share a reference point in being marked up from a benchmark return, modeling private equity or debt returns is not straightforward, due to a lack of good-quality data, more security-specific risk between assets, and artificially smooth returns.

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Private Capital: Question

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Investing in private debt and equity mirrors the risk-return pathway for traditional equity and debt investing. As investors select between senior and junior debt and between equity and debt, the potential risks and returns increase. Therefore, the lowest risk and return come from senior direct lending, and the highest risk and return are from private equity, while mezzanine financing falls in between the two.

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