Learning Module 3: Investments in Private Capital: Equity and Debt

LOS 3a: explain features of private equity and its investment characteristics

Private capital refers to the funding provided to companies not sourced from public markets or traditional institutional providers such as government or banks. Private capital consists of private equity and private debt.

Private Equity

Private equity is an investment in privately owned or public companies to privatize them. A private equity firm manages a private equity fund as a collection of investments. The company in which the firm invests is referred to as a portfolio company. Some of the primary strategies of private equity include:

- Leveraged buyouts.
- Venture capital.
- Growth capital.

Leveraged Buyout (LBO)

Leverage buyouts entail private equity firms creating buyout funds for the purpose of purchasing publicly traded or well-established private companies. A substantial portion of the acquisition cost is funded through borrowing, with the target company's assets serving as security for the borrowed funds. It is anticipated that the cash flows generated by the target company will be ample to cover the debt obligations. Following the transaction, the target company transitions into private ownership or maintains its existing private status.

LBOs are two-fold: management buyouts (MBOs) and management buy-ins (MBIs). In a management buyout (MBO), the existing management team is retained and incorporated into the acquisition. On the other hand, in management buy-ins (MBIs), the current management team is replaced with the acquiring company's management.

LBO managers aim to add value by improving company operations, boosting revenue, and ultimately increasing profits and cash flows.

Venture Capital (VC)

Venture capital (VC) involves providing financial support to or investing in private companies with high growth potential. Financed companies are usually startup companies. Nevertheless, venture capital is also applicable to companies at any growth stage, provided the company in question qualifies for funding. It is, however, imperative to note that the venture capital extended to a startup company will demand higher returns due to high-risk potential. Equally noteworthy is the fact that venture capitalists are active investors.

Venture capitalists invest in companies and earn an equity interest. In other words, they provide funding in the form of debt. Given the foregoing clarifications, we have three stages of venture capital financing:

Like all private equity managers, venture capitalists are active investors who are directly involved with their portfolio companies. They typically invest in companies and receive an equity interest but may also provide financing in debt, often convertible debt.

Convertible preferred shares are often used in startups to raise private capital from venture capital funds. These shares include an option for the holder to convert the preferred shares into a fixed number of common shares after a predetermined date and price. This provides incentive alignment between the entrepreneurs in the startup and the investor.

In the event of a liquidation, preferred convertible shareholders have seniority over common shareholders and are entitled to recover the entire value of their investment before common shareholders receive any of the proceeds.

Stages of Venture Capital

1. **Pre-seed capital or angel investing:** Funds are provided at the conception or idea stage. The funds are invested in turning a business idea into a workable business plan. At this stage, funds are sourced from individuals dominantly made up of family and friends. Note that venture capital (VC) funds are usually not utilized at this point.
2. **Seed-stage financing (seed capital)**: This is the stage where VC is used. The funds are used for product development and market processes such as market research.
3. **Early-stage financing (early-stage VC), or startup stage financing**: This is where funds are given to companies on the verge of launching operations.
4. **Later-stage Financing (Expansion Venture Capital)**: Later-stage financing involves providing funds to companies after starting commercial production and sales. The funds may support initial growth, expansions, or significant marketing. Nevertheless, this happens before they venture into an initial public offering (IPO).
5. **Mezzanine-stage Financing**: In mezzanine-stage financing, the financed company is prepared to go public. The company is thus financed until its IPO is completed or sold. Note that the term mezzanine implies that a company is financed as it transitions from private to public.

It's important to distinguish between mezzanine financing and mezzanine-stage financing. **Mezzanine financing** refers to using equity-debt hybrid instruments, such as convertible debt or convertible preferred. In contrast, **mezzanine-stage financing** can use mezzanine financing, but at this stage, the primary financing is typically either equity-like or short-term debt aimed at capturing potential gains from the planned IPO.

Growth Capital

Another type of private equity is growth capital, also called growth equity or minority equity investing. Growth capital involves minority equity investments. It is a case in which a firm owns a less-than-controlling interest in more mature companies seeking funds for expansion or restructuring, venturing into new markets, or funding significant acquisitions.

Usually, it is the management of the receiving company that requests growth capital. The requisitioning company aims to profit by selling a percentage of its shares before it goes public.

The company aims to retain its existing management and consolidate its accomplishments.

Note that publicly quoted companies can also seek private equity capital through **private Investments in public equities (PIPEs),** where private offerings are made to select investors such as investment firms, mutual funds, or other institutional investors. This method of raising capital is characterized by fewer disclosures and lower transaction costs, making it a quicker and more cost-effective alternative to other, more regulated means.

In a traditional PIPE transaction, the securities offered can be newly issued common stock, shares sold by existing stockholders, or a combination of both. These investors enter into a definitive purchase agreement with the issuer, committing to purchase the securities at a fixed price. PIPE transactions are commonly used in work-out or rescue situations, where there is a significant difference between the market price and valuations.

PIPE transactions can be dilutive to existing shareholders. This is because the new investors typically require a discount from the market on the purchase price. This can introduce incentive conflicts between existing shareholders and new shareholders.

Private Equity Exit Strategies

Private equity firms aim to enhance the performance of businesses and then sell them at higher valuations. The decision on an exit strategy is influenced by several factors, including the dynamics of the industry in which the portfolio company operates, the overall economic cycle, interest rates, and the company's performance.

A private equity fund typically has an investment period of about five years, followed by a harvesting period when the exit occurs and the valuation environment becomes more relevant. It's important to note that investments in private equity funds are not made in a single payment. Instead, they are spread over time using committed capital over several years. This approach gives managers significant flexibility to optimize their entry and exit points.

There are two primary exit strategies: **trade sale** and **public listing**.

Trade Sale

A trade sale involves selling a portion or a division of a private company either through a direct sale or an auction to a strategic buyer.

This buyer is typically interested in expanding the scale and scope of their existing business. However, this type of transaction can impact the competitive environment, leading to potential regulatory scrutiny and approval. It may also face resistance from management or employees who may fear layoffs.

Advantages of Trade Sale

- There is an immediate cash exit for the private equity fund.
- There is the motivation for strategic buyers to pay more because they anticipate integration with their businesses.
- The trade sale is fast and straightforward.
- Transaction costs are lower compared to an IPO.
- There are lower levels of disclosure and, hence, higher confidentiality compared to an IPO.

Disadvantages of Trade Sale

- There is potential opposition from the management.
- It is less attractive to portfolio company employees than those for an IPO since employees can monetize the shares.
- There is a limited number of potential trade buyers.
- There is a possibly lower price for the sale compared to an IPO.

Public Listing

Public listing on an exchange can occur through three main methods:

- **Initial public offering (IPO)**,
- **direct listing**, or
- **special acquisition company (SPAC)**.

Initial Public Offering (IPO)

The most prevalent method is the IPO, which involves raising capital in public equity markets by selling its shares with the help of financial intermediaries who underwrite the offering. For instance, when Facebook went public in 2012, it was through an IPO.

Advantages of an IPO

- There is a chance of selling shares at the highest price.
- There is a high chance of management approval since it is retained.
- It enhances a private equity firm's publicity/visibility.
- If private equity holds onto some shares, there will be future upside potential.

Disadvantages of an IPO

- High transaction fees to investment banks and lawyers,
- A potentially long completion time and the requirement for onerous disclosure.
- The public equity market also introduces stock market volatility.
- The potential lockup period (which mandates the private equity firm to retain an equity position for a specified period post-IPO) may limit a quick realization of value.
- Not all companies are suitable for an IPO. Smaller companies, those operating in out-of-favor industries, ones with unclear strategic priorities and unstable financial positions, may not be ideal candidates for an IPO.

Direct Listing

In this method, the equity of the entity is floated on the public markets directly, without underwriters. This reduces the complexity and cost of the transaction. For example, Spotify chose to go public through a direct listing in 2018, bypassing the traditional IPO process.

Special Purpose Acquisition Company (SPAC)

A Special Purpose Acquisition Company (SPAC) is a financial tool used for a public exit strategy. It can be considered a "blank check" entity established solely to acquire an unspecified private company within a predetermined timeframe. For example, a SPAC could be formed to acquire a tech startup within two years.

Should it fail to achieve this objective, it is obligated to return the invested capital to its backers. Companies suitable for an Initial Public Offering (IPO) are often suitable candidates for SPACs. However, it's important to note that the methods used for valuing SPACs and IPOs differ. With SPACs, a single party establishes the terms, which helps reduce the risks surrounding the valuation.

Advantages of SPAC Exit

- Extended time for public disclosure on company prospects to build investor interest: Unlike traditional IPOs, SPACs allow for a longer period of time to disclose information about the company, which can help build investor interest.
- The flexibility of transaction structure to best suit the company's context: SPACs offer more flexibility in structuring the transaction, which can be tailored to suit the specific needs of the company.
- Association with potentially high-profile and experienced sponsors and their extensive investor network: SPACs are often sponsored by high-profile individuals or firms, which can bring credibility and a broad investor network to the table.
- The valuation of the entity is fixed in advance and does not change, reducing both the

volatility and the uncertainty of share pricing.

- SPACs) are permitted to offer more comprehensive forward-looking guidance regarding a company's potential than an IPO: This allows the company to provide more detailed information about its prospects, which can help attract investors.

Disadvantages of SPAC Exit

- SPAC transactions raise the cost of capital due to the dilutive effects of various capital instruments, such as warrants. This means that the value of existing shares can be diluted, increasing the cost of capital. For example, if a SPAC issues new shares to raise capital, the value of existing shares might decrease.
- There exists a valuation gap between the value of SPAC equity and the equity acquired by SPAC. This can be further complicated by possible dilution effects:
- Particular deal-related risks could also be linked to the successful execution of the definitive purchase and merger agreement. This refers to the risk that the deal might not go through as planned. For example, regulatory hurdles or disagreements between the parties could derail the deal.
- Regulatory authorities, including the US SEC, are reevaluating the categorization of SPACs under well-established regulations that may introduce stricter operating standards. This could make it more difficult for SPACs to operate and impact their attractiveness to investors.
- There can be substantial trading activity in SPAC equity in the months following the announcement of a purchase transaction, resulting in a stockholder overhang. This influx of large blocks of shares sold on the open market can exert downward pressure on the share price, causing volatility and potentially diminishing the value of the shares.

Other Exit Strategies

In private equity, a firm has several other exit strategies at its disposal. These strategies include **recapitalization**, **secondary sale**, and **write-off/liquidation**.

Recapitalization

Recapitalization is a strategy involving the firm increasing or introducing leverage to its portfolio company and paying itself a dividend from the new capital structure. For example, a private equity firm might introduce debt into a previously debt-free company and then use the borrowed money to pay a dividend to itself.

This is not a true exit strategy, as the private equity firm typically maintains control. It allows the private equity investor to extract money from the company to pay its investors and improve its internal rate of return (IRR).

Secondary Sale

A secondary sale is another exit strategy that involves the sale of the company to another private equity firm or group of financial buyers. For instance, a private equity firm might sell a successful startup to another private equity firm.

Write-off/Liquidation

A write-off or liquidation takes place when a transaction has not performed well, and the investment will probably depreciate. The private equity firm then revises the value of its investment downward or liquidates the portfolio company before moving on to other projects.

Private Equity Investment Categories

Private equity investments can be categorized into direct and indirect investments. **Direct investments** are those made in a single, specific asset. For instance, an investor might directly invest in a startup company like Uber or Airbnb.

On the other hand, **indirect investments** are made through a fund-of-funds vehicle that holds stakes in various other private funds. This is akin to investing in a mutual fund that holds a portfolio of different stocks.

Another form of private equity investment is **co-investments**, where the investor participates alongside a main sponsor who sources, structures and executes the transaction. This is similar to a scenario where an investor partners with a venture capital firm to invest in a promising startup.

Risk–Return from Private Equity Investments

Higher-Return Opportunities

Private equity funds may offer higher return opportunities compared to traditional investments. This is due to their ability to invest in private companies, influence portfolio companies' management and operations, and use of leverage. Using leverage or borrowed money, can also amplify returns if the investment is successful.

Risks

Investing in private equity, including venture capital, is riskier than investing in common stocks. It requires a higher return for accepting its higher risk, including illiquidity and leverage risks. Illiquidity risk refers to the difficulty of selling an investment, while leverage risk refers to the potential for losses if the investment does not generate enough return to cover the cost of borrowed money.

Comparing Private Equity and Public Equity

Both private equity and public equity entail direct ownership and control of a company. In both cases, owners are shareholders with voting rights at the annual general meeting of shareholders, and they have a direct and proportionate claim to residual cash flow rights through dividends.

However, private equity ownership offers greater direct control over decision-making than public equity, primarily because of substantial shareholdings. Consequently, effectively managing direct private investment exposure necessitates specialized knowledge specific to the industry and sector in which the firm operates.

Question

Which of the following *best* describes private capital?

A. Funding is sourced from public markets or traditional institutional providers such as government or banks.
B. Funding is provided to companies that are sourced from private sources in the form of equity investment only, known as private equity.
C. Funding is provided to companies that are sourced from private sources in the form of equity investment and capital extended to companies through a loan or other form of debt, referred to as private debt.

The correct answer is C.

Private capital refers to the funding provided to companies not sourced from public markets or traditional institutional providers such as government or banks. Private capital is a broad term that encompasses both private equity and private debt.

Private equity refers to investments made in private companies or public companies that are being taken private by investors who typically take a long-term view and seek to add value through active management. On the other hand, private debt refers to loans or other forms of debt extended to companies by private lenders rather than through the public markets. Private capital is often sought by companies that cannot access public markets or prefer the flexibility and discretion that private capital can offer. It is a crucial funding source for startups and companies seeking to grow or restructure.

A is incorrect. Private capital does not refer to the funding sourced from public markets or traditional institutional providers such as government or banks. These are considered public sources of capital, not private.

B is incorrect. Private capital does not refer only to the funding provided to companies sourced from private sources in the form of equity investment, known as private equity. It also includes private debt, capital extended to companies through a loan or other form of debt by private lenders.

LOS 3b: explain features of private debt and its investment characteristics

Private debt refers to the various forms of debt provided by investors directly to private entities. The expansion of the private debt market in the past decade has been largely driven by private lending funds. After the 2008 financial crisis, banks were more cautious in lending due to stricter regulations. This created an opportunity for private lending funds to step in and provide the necessary capital to businesses.

There are four primary methods of private debt investing: **Direct lending, mezzanine loans, venture debt,** and **distressed debt.**

1. Venture Debt

Venture debt is private funding given to start-ups or early-stage firms that may generate small or negative cash flow. Companies may seek venture debt, often in the form of a line of credit or term loan, to obtain additional financing without further diluting shareholder ownership. For example, a tech startup might seek venture debt to fund its research and development activities without having to give up more equity.

Venture debt can complement existing equity financing, allowing current shareholders to maintain ownership and control for a longer period. It may carry additional features that compensate the investor/lender for the increased risk of default or for the start-up and early-stage companies that lack substantial assets for debt collateral.

2. Direct Lending

Direct lending involves private debt investors offering capital to borrowers directly. In return, the private debt investors receive interest, the original principal, and other required repayments. Private debt is like a typical bank loan since it has a fixed structure of payments. It is a senior and unsecured loan containing covenants to protect the lender and the borrower.

In direct lending, a private equity firm collects funds from investors seeking higher-yielding debt. The fund managers then use the funds to grant loans to entities such as private equity funds. The interest rate in private equity is relatively higher since the entities seeking capital lack an alternative to bank loans-usually, banks may have denied them loans.

Direct lending may be done through a leveraged loan. In the case of a leveraged loan, private debt firms borrow to fund a private debt and then extend a loan to another borrower. A leveraged loan has the potential to increase private debt firms' returns.

3. Mezzanine Debt

Mezzanine debt is a private debt subordinate to senior secured debt but senior to equity in the borrower's capital structure. In other words, mezzanine debt is a pool of extra funds available to borrowers above senior secured debt. Mezzanine debt is usually common in financing leveraged buyouts (LBOs), recapitalization exit plans, acquisitions, and similar structures.

Mezzanine debts are riskier than senior secured debts since they are unsecured. As such, the interest rate investors charge in mezzanine debt is higher and may involve options for equity participation. Other features of mezzanine loans are the warrants or conversion rights, which allow for equity participation – converting debt into equity or buying a borrower's equity in particular conditions.

4. Distressed Debt

Distressed debt investors buy the debt of mature companies battling financial challenges such as bankruptcy, defaulting on debt, or nearing default. Distressed debt is usually appropriate for companies experiencing temporary cash flow difficulties but that have good business plans, remain afloat, and later succeed. As such, distressed debt investors purchase the debt and actively involve themselves in running the company in a bid to restructure and revive it.

Investors concentrating on distressed debt need to develop specialized knowledge related to assessing the likelihood of default and the possible recovery rates. Bankruptcy procedures can be lengthy, complex, and capital-intensive.

Similarly, distressed debt investors need to understand how to restructure companies and restructure debt. For instance, an investor might buy the distressed debt of a struggling retail chain, betting that the company can turn its fortunes around or that the recovery rate on the debt will be high enough to make the investment profitable.

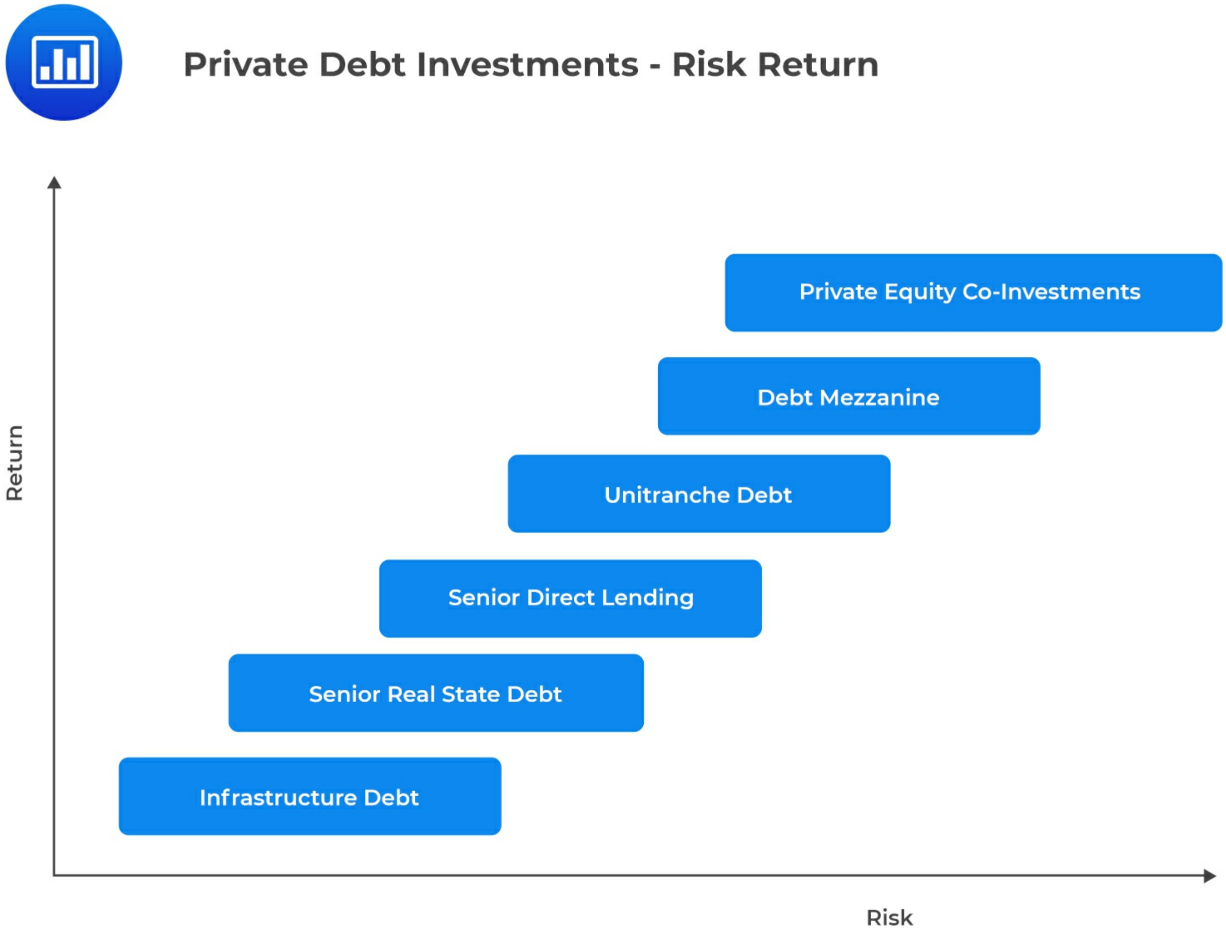
5. Unitranche Debt

Unitranche debt is made of a combined or hybrid loan structure. It is a blend of different tranches of unsecured and secured debts that collectively form a single loan with a single, blended interest rate that falls between the interest rates of secured and unsecured debts. As such, unitranche is ranked between senior and subordinated debts.

For example, a private debt firm might extend a unitranche loan to a healthcare company looking to acquire a competitor, combining secured debt (backed by the company's assets) and unsecured debt (not backed by any collateral) into a single loan with a blended interest rate.

Risk–Return Profile of Private Debt

Private debt investments have become an appealing alternative for fixed-income investors seeking higher yields compared to traditional bonds such as government or corporate bonds. Larger levels of risk are linked to the possibility of higher rewards, as seen in the graph below:



Illiquidity Premium and Portfolio Diversification

The allure of private debt largely comes from the **illiquidity premium**, which compensates investors for the lack of liquidity associated with these investments as opposed to public bonds.

Additionally, private debt can enhance portfolio diversification as its returns may not correlate with those from other asset classes.

Interest Rate Benchmarking

The interest rates on private debt are often benchmarked to reference rates like the **Secured Overnight Financing Rate (SOFR)**, with a specified number of basis points added on. For instance, if SOFR is 2% and the private debt offers SOFR + 200 basis points, the interest rate on the private debt would be 4%.

This mechanism ensures that the coupon rate of the debt fluctuates with changes in the broader interest rate environment.

Key Differences Between Public and Private Debt

Private debt entails distinct entry and exit points with lenders, providing borrowers with more flexibility in financing arrangements. Specialized knowledge is necessary to navigate private debt financing, with investors needing to understand the borrower's industry, financial health, and loan agreement terms.

Debt Financing Across Company Life Cycles

The phase of a company’s life cycle significantly impacts the risk and return profile of debt financing. Early-stage debt financing usually carries higher risks but also offers higher returns.

Risk and Return Variability in Private Debt

The spectrum of private debt offers varying levels of risk and return. Senior private debt, for instance, provides a steadier yield with moderate risk, while mezzanine private debt presents higher growth potential, equity upside, and increased risk.

Comparative Risk Analysis

Investing in private debt is generally riskier than traditional bonds. It's imperative that investors are cognizant of the associated risks, including illiquidity and heightened default risk, especially when loans are extended to riskier entities or in precarious situations.

Challenges in Modeling Private Debt Returns

The modeling of private equity or debt returns is complex due to the scarcity of high-quality data and the tendency for returns to be artificially smoothed. This is partly because private debt returns are often based on appraisals rather than market prices, and these investments usually lack a set maturity date.

Private Debt Methods of Investment

Private debt investment, much like private equity investment, provides a range of choices for investors based on the direct versus indirect investment approach.

In direct private debt investment, the investor lends directly to a specific operating company. In the indirect approach, the investor purchases an interest in a fund that pools contributions to buy into the debt from a set of operating companies. This could be likened to an investor buying into a mutual fund that invests in the debt of companies.

Question

Which of the following is *most likely* the primary factor that led to the expansion of the private debt market after the 2008 financial crisis?

A. The rise in the number of private lending funds.
B. The increased demand for borrowing from private entities.
C. The reduced lending supply from traditional lenders due to stricter regulations.

The correct answer is C.

After the financial crisis, banks and other traditional lenders faced stricter regulations and higher capital requirements, which made them more cautious in their lending practices. This created a gap in the market, as the demand for borrowing remained high, particularly from small and medium-sized enterprises that were unable to access traditional sources of finance.

This gap was filled by private lending funds, which were able to provide the necessary capital to these borrowers. The growth of the private debt market was therefore driven primarily by the reduced supply of lending from traditional lenders rather than by an increase in demand or the rise in the number of private lending funds.

A is incorrect. The rise in the number of private lending funds was a response to the gap in the market created by the reduced lending supply from traditional lenders rather than a primary driver of the expansion of the private debt market. These funds were able to step in and provide the necessary capital to borrowers who were unable to access traditional sources of finance, thereby contributing to the growth of the private debt market.

B is incorrect. While the demand for borrowing from private entities may have increased after the financial crisis, this was not the primary factor driving the expansion of the private debt market. The key driver was the reduced supply of lending from traditional lenders, which created a gap in the market that was filled by private lending funds.

LOS 3c: describe the diversification benefits that private capital can provide

The performance of private debt and equity investments is primarily influenced by the particular stage of a company's life cycle, its performance, and the associated risks. Consequently, it may not be appropriate to directly compare them with public debt and equity due to the following reasons:

- Investing in an early-stage startup bears more risk than investing in a well-established company.
- Making an investment in a company within a declining industry, like a traditional print newspaper company, is unlikely to generate favorable returns over extended time periods.
- It is relatively easy to hedge against the performance risk associated with ongoing investments in public equity and debt.

Vintage Year

The vintage year plays a significant role in the comparative analysis of private equity and venture capital (VC) investments against other funds from the same period. A vintage year is commonly described as the year when a fund initiates its initial investment activities. For example, a private equity fund that embarked on its first investment in 2010 would fall under the category of a 2010 vintage fund.

Typically, a private equity fund functions within a timeframe spanning 10 to 12 years, typically divided into an initial **investment phase** and a subsequent **harvesting phase**. The initial investment phase, typically covering the first five years, involves sourcing capital from limited partners and deploying it into diverse companies. The harvesting phase encompasses the remaining years of the fund's life, during which the fund endeavors to divest its current investments and provide returns to its limited partners.

Vintage Diversification

As a result of evolving business conditions, funds from specific vintage years have the advantage of commencing their operations during a phase characterized by lower valuations and reduced risk appetite, often coinciding with an economic recovery period. This positions them to capitalize on the upswing in the economy. Conversely, other vintage years may face less favorable circumstances, directing most of their investments into a high-valuation environment that precedes a market downturn or an extended economic contraction.

Hence, it is advisable for investors to pursue diversification across various vintage years. For instance, funds initiated during the expansion phase of the business cycle, like those in the early 2000s, tend to achieve above-average returns when they invest in early-stage companies. On the other hand, funds launched during the contraction phase of the business cycle, such as those in the late 2000s, tend to realize above-average returns when they invest in distressed companies.

Investments in Private Capital

Investments within the world of private capital exhibit varying levels of risk and return, organized along the corporate capital structure hierarchy.

Generally, private equity, which is recognized as the riskiest option, tends to yield the highest returns, while private debt offerings display diminishing returns along a spectrum, with infrastructure debt offering the least risk and return.

Introducing investments in private capital funds can contribute a moderate diversification advantage to a portfolio comprised of publicly traded stocks and bonds.

Question

The principle of vintage diversification:

A. involves investing in funds from the same vintage year to maximize returns.
B. is a strategy that advises investors to invest in funds seeded during the contracting phase of the business cycle only.
C. is a strategy that advises investors to spread their investments across funds from different vintage years to take advantage of varying economic conditions.

The correct answer is C.

Vintage diversification is indeed a strategy that advises investors to spread their investments across funds from different vintage years to take advantage of varying economic conditions. This strategy is based on the understanding that the performance of funds can be significantly influenced by the economic conditions prevailing at the time of their inception. By diversifying investments across different vintage years, investors can mitigate the risks associated with changing business and valuation environments.

A is incorrect. Vintage diversification does not involve investing in funds from the same vintage year to maximize returns. This would actually concentrate the risk associated with changing business and valuation environments rather than mitigating it.

B is incorrect. Vintage diversification is not a strategy that advises investors to invest in funds seeded during the contracting phase of the business cycle only. While such funds can earn excess returns if they fund distressed companies, this is only one aspect of the vintage diversification strategy. The strategy also involves investing in funds seeded during other phases of the business cycle to take advantage of varying economic conditions.