

## Private Investments: Potential Rewards for Individuals and Institutions

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## Private investments defined

Private investments include the equity and debt obligations of companies that are not traded on organized exchanges. There are far more private companies than publicly traded ones, so including them can significantly increase the opportunities for investors. Private investments have been one of the fastest growing asset classes over the last 10 years. Individuals and institutions might want to consider adding private investments to their portfolios because:

- Returns are expected to be higher than those available in publicly traded markets.
- Properly employed, private investments can improve the diversification and efficiency of most portfolios.

In this white paper, we help demystify private investments and bring the potential rewards into sharper focus by defining the various asset categories, looking at the partnership structure, examining how funds can produce attractive returns for the patient investor, and exploring the risks to investors.

## Private equity and private real assets

Private investments fall into the following categories: private equity, private debt, and private real assets. Private equity and private real assets offer opportunities for growth, while private real assets may also help protect against unexpected increases in inflation. Private debt investing is generally intended to produce income, though it may also generate growth when investing in lower quality issues. Figure 1 shows what each of the options has to offer. Potential risks and returns are illustrated in Figure 2.

### Private equity investing

*Venture capital* — This high risk category funds start-up companies, allowing them to explore promising but untested business ideas and management teams. Venture capital is often concentrated in emerging technologies, which means less diversification. Funds can be invested at any of the four stages of a company's development:

- Angel investing occurs at the idea stage of development.
- Seed funds are typically used to develop prototypes.
- Early-stage investing is used to fund the development of productive capacity.
- Late-stage investing is used to fund the expansion of existing facilities.

*Leveraged buyouts* — In this category, publicly traded companies are acquired and taken private. The strategies distinguish themselves by the size of the companies they acquire: small, medium, or large. Debt financing is a major source of funding and is typically secured by the target company's cash flow. A leveraged buyout can be motivated

by any number of factors, including optimization of the balance sheet, increasing operating efficiencies, improving the management team or its incentives, and redirecting cash flow toward equity holders.

*Mezzanine financing* — This is a hybrid of private debt and equity financing that is targeted toward "middle market" borrowers who are not big enough to gain access to capital through the high yield debt market. Mezzanine financing is usually inserted into the capital structure between equity holders and senior debt holders, and is meant to be flexible to meet the specific needs of each borrower. This type of financing often takes the form of debt or preferred stock. Debt financing is typically unsecured, but often includes an "equity kicker" like a warrant or other convertible feature. Mezzanine borrowers may have the option of making "in-kind" interest payments, which allow them to avoid cash interest payments in lieu of some specified noncash payment, such as additional debt or equity.

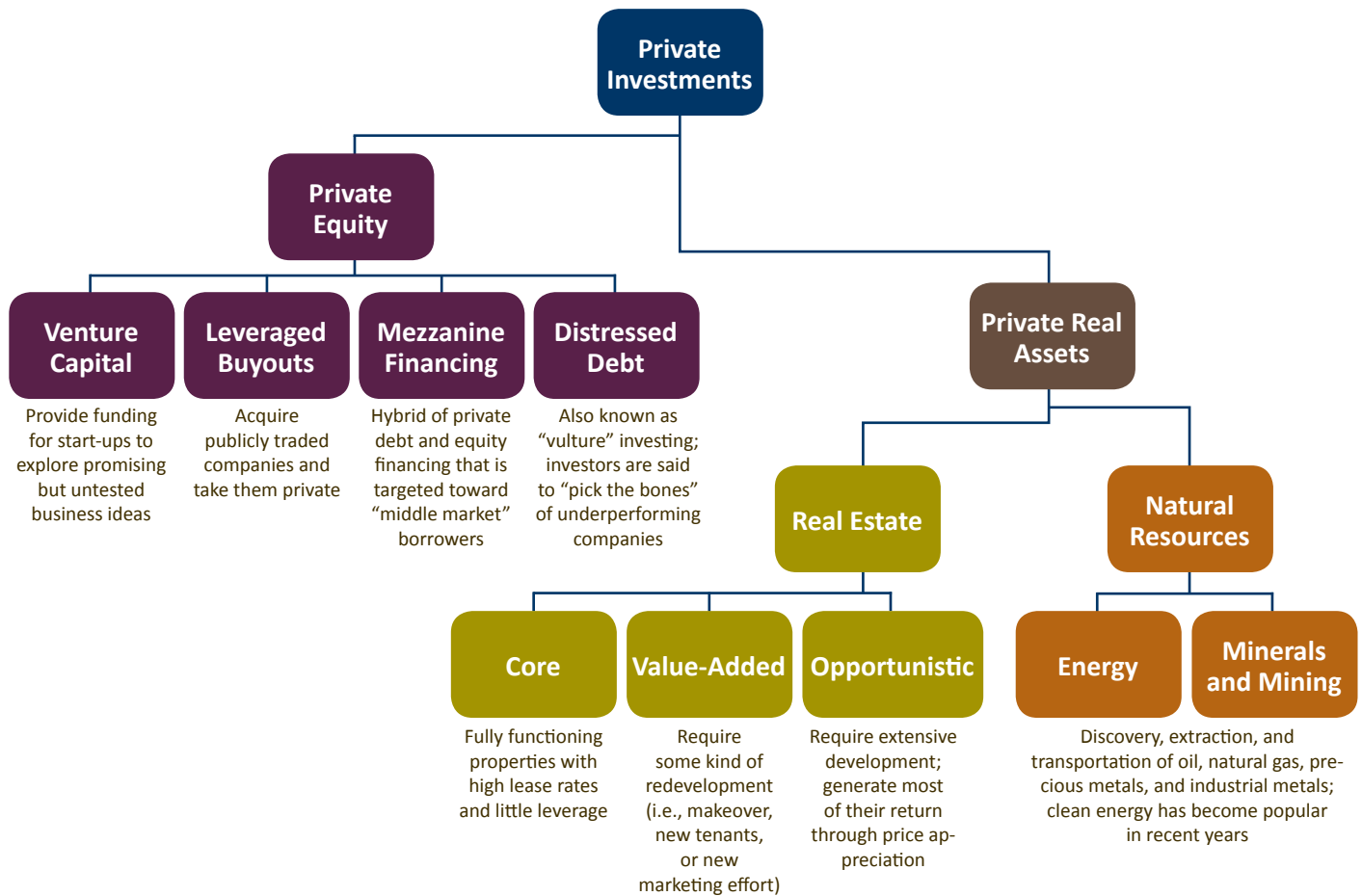
This type of financing has many uses, including management buyouts, funding growth opportunities, and bridge financing. Loans are typically secured by the cash flow of the borrower. Mezzanine debt usually includes a "take out" provision, which allows the debt holder to pay off all of the more senior loans, resulting in the highest credit position on the balance sheet. This strengthens the mezzanine debt holder's bargaining position in most situations.

*Distressed debt* — Known as "vulture" investing because investors are said to "pick the bones" of underperforming companies, distressed debt is more closely akin to equity investing because the target company may be on the brink of default or already in bankruptcy. It nearly always involves a borrower who is under some kind of financial strain. Remedies include a work-out, turnaround, reorganization, or bankruptcy. A detailed understanding of the bankruptcy process is critical to successful distressed investing.

Most of this debt comes from banks and finance companies that are trying to remove it from their balance sheets. The debt is usually the result of a company's financial condition deteriorating over a long period of time due to any combination of operating inefficiencies, poor management, or a faulty business plan. The most talented distressed investors can bring a fresh approach to troubled companies.

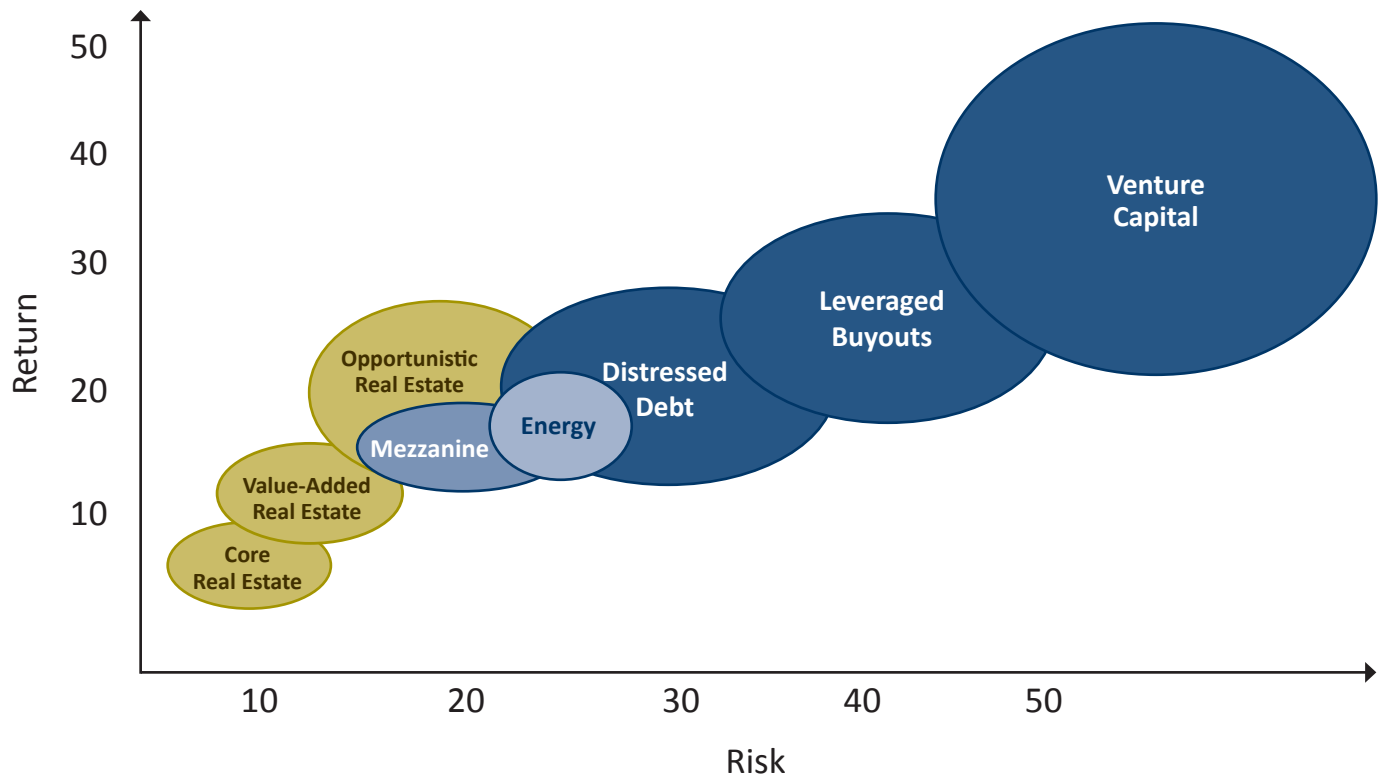
Distressed investors may seek eventual control of a target company or to merely gain some equity exposure to it.

Figure 1: Private Investment Opportunities



Source: CAIA, Level I, An Introduction to Core Topics in Alternative Investments (2009, Chartered Alternative Investment Analyst Association)

Figure 2: Private Investment Risk/Return Expectations



Source: CAIA, Level I, An Introduction to Core Topics in Alternative Investments (2009, Chartered Alternative Investment Analyst Association) and CAIA, Level II, Advanced Core Topics in Alternative Investments (2009, Chartered Alternative Investment Analyst Association)

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### Private real estate

Real estate investments can be placed into three broad categories: core properties, value-added properties, and opportunistic properties.

**Core properties** — High quality office buildings, apartments, retail, and industrial space are common examples. They tend to be the least volatile, earn most of their return from income, and are fully functioning properties with high lease rates and little leverage.

**Value-added properties** — These properties require some kind of redevelopment, such as a makeover, new tenants, or a new marketing effort. Examples include specialty retail, hospitality, senior or assisted living facilities, storage, and low-income housing. The cost of redevelopment and frequent use of leverage make value-added properties moderately more risky than core properties.

**Opportunistic properties** — These properties are typically nonfunctioning and include speculative developments and undeveloped land. They require extensive improvements and generate most of their return through price appreciation. The holding period for these properties tends to be shorter (three to five years) and a significant amount of leverage is usually employed.

### Private natural resources

Private investing in natural resources includes the discovery, extraction, and transportation of oil, natural gas, precious metals, and industrial metals. Clean energy has also become popular for private investments in recent years, though its results have been mixed.

One common strategy is to locate and acquire small tracts of “mature” properties from large-scale producers and then employ talented management teams using new technologies to improve production. Mature fields have seen their production fall in recent years and the large-scale producers do not want to spend time and money developing them any further.

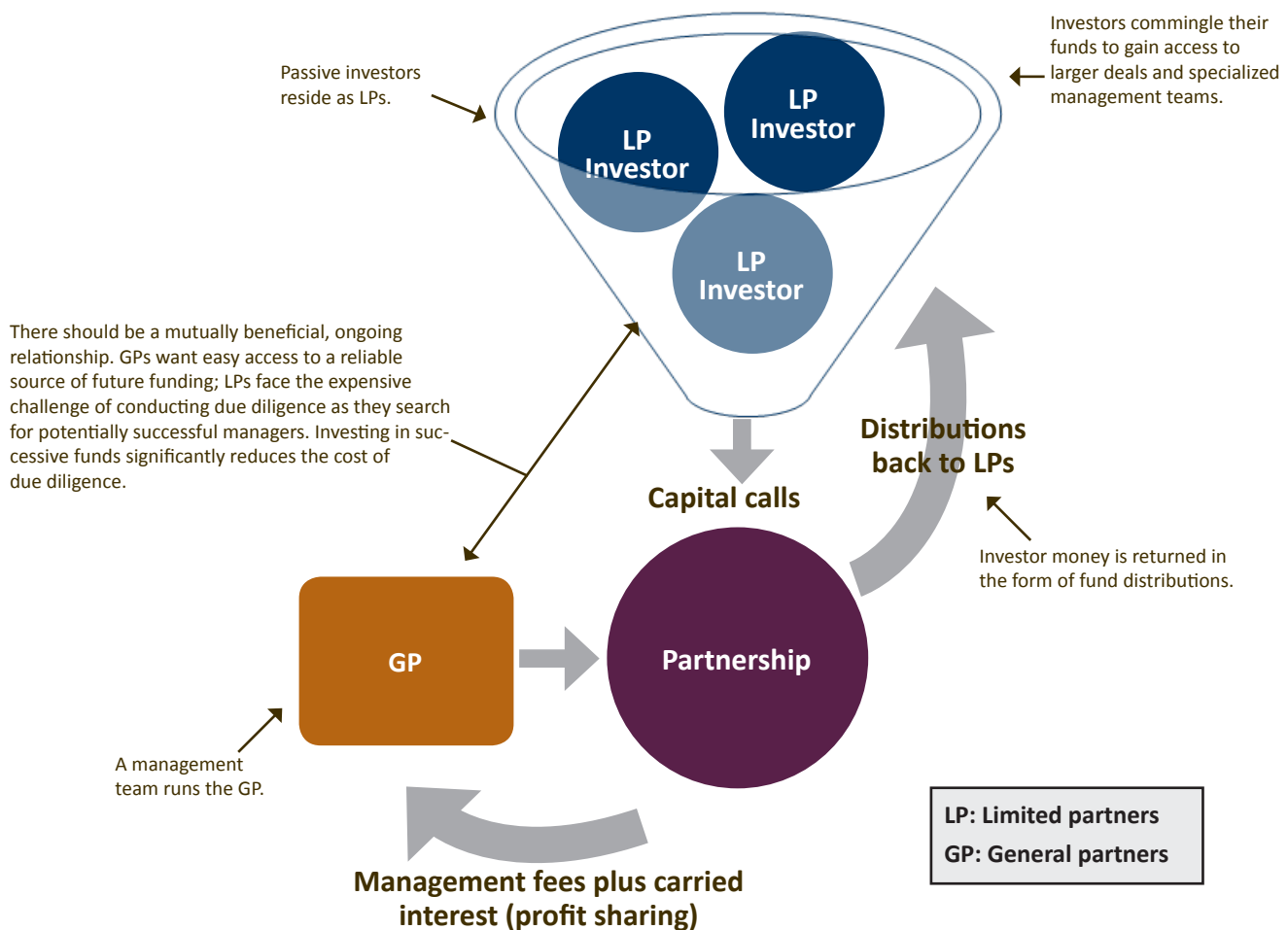
Another strategy is to fund infrastructure projects, such as oil, natural gas, and electricity transmission and distribution systems.

### Partnership interests

Partnerships are the foundation of private investing. Figure 3 illustrates how a management team leads the general partner (GP), while passive investors are limited partners (LPs) or limited liability corporations (LLCs). Through these business relationships, investors commingle their funds and gain access to larger deals and specialized management teams.

The *Securities Act of 1933* generally limits access to private investments to several classes of accredited investors. One class includes individuals with a minimum annual income of \$200,000 or more (\$300,000 with spouse) or net worth in excess of \$1 million (excluding their primary residence). There are other classes used by some funds that require a higher level of personal worth.

Figure 3: Partnership Structure Provides the Foundation



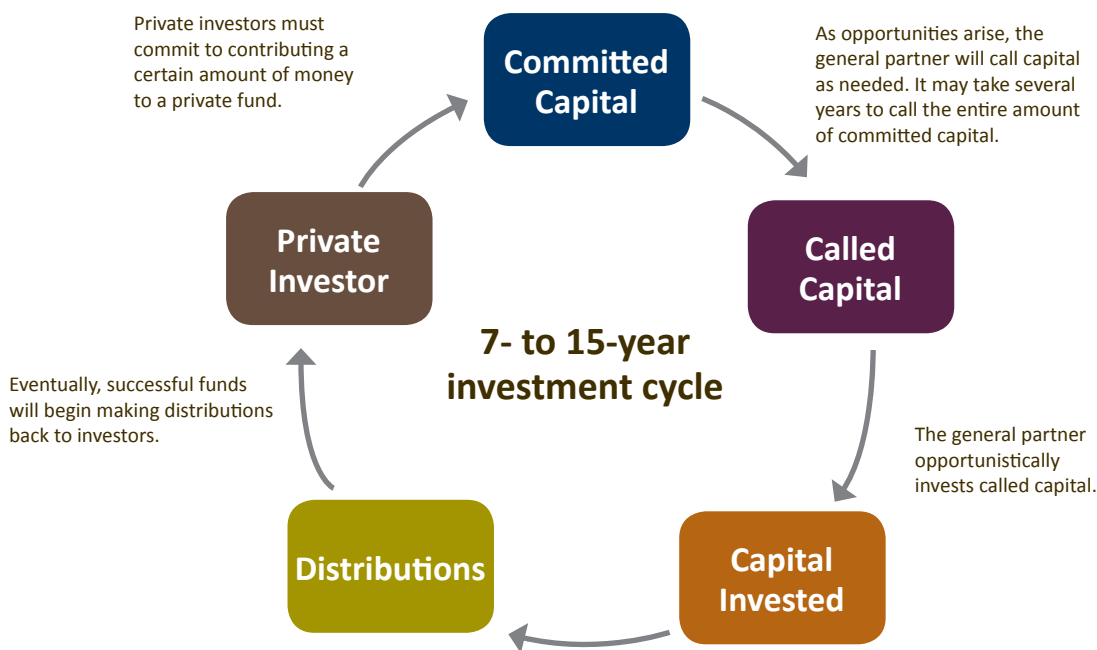
## Committed capital, called capital, and distributions

Private investors must sign subscription agreements that commit them to contributing a certain amount of money to a private fund. Note that it may take several years to call the entire amount of committed capital. This is called “investment period” and its estimated duration is usually found in the marketing materials and private placement memorandum (PPM). Since the timing of these capital calls is uncertain, investors are advised to keep sufficient liquidity available to cover them with only a few weeks notice. Figure 4 shows how the GP calls capital from investors.

Eventually, successful funds will make distributions back to investors. While it is difficult to generalize, the following terms are not unusual. First, the LPs receive 100 percent of all distributions until their entire initial investment has been recouped. The LPs continue to receive all distributions until they earn a “preferred return.” Next, GPs are typically entitled to receive all distributions (also called “carried interest”) up to a certain threshold. Once the GP’s threshold has been reached, the remaining distributions are split on some pro-rata basis. This type of distribution structure is aptly named the “distribution waterfall.” All of the terms and conditions surrounding distributions can be found in the PPM.

Private investments nearly always have a finite life, usually five to 10 years. It is also typical for the GP to have the option of extending the life of the partnership for multiple one-year terms, in order to efficiently wind-down and/or liquidate the partnership’s investments.

Figure 4: Committed Capital, Called Capital, and Distributions

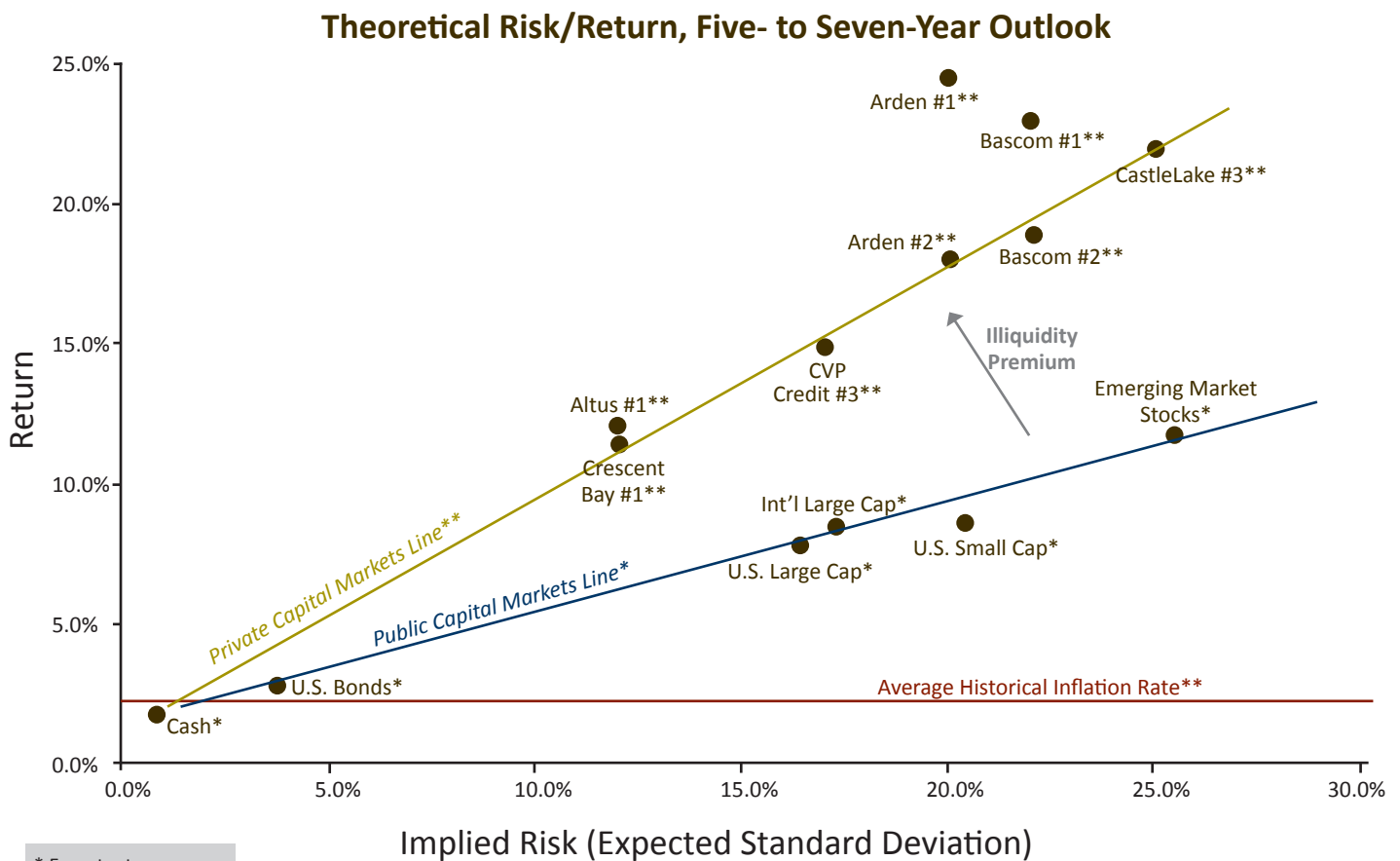


## Return expectations

Private investments are expected to generate higher returns than their publicly traded counterparts for three reasons:

1. Higher management fees should attract more talented fund managers who have superior knowledge of a particular market or market niche.
2. Private markets have fewer potential investors due to the “accredited investor” restriction, so there is less capital flowing into private markets. Conversely, the extensive capital flowing into publicly traded investments tends to push up prices, diluting forward expected returns.
3. Private investors must lock up their money for a long period of time with virtually no liquidity. Consequently, they should expect to earn an additional “illiquidity risk premium.” Figure 5 illustrates this concept. Standard deviation, or “implied risk,” refers to the tendency of an investment’s return to deviate from an anticipated average (or “mean”) return for that investment over time. A greater implied risk indicates a greater amount of uncertainty surrounding the actual return that will occur in future years.

Figure 5: Illiquidity Premium of Private Investments



\* Envestnet  
\*\*CLA Wealth Advisors

Source: CliftonLarsonAllen Wealth Advisors, LLC, and Envestnet | Tamarac™

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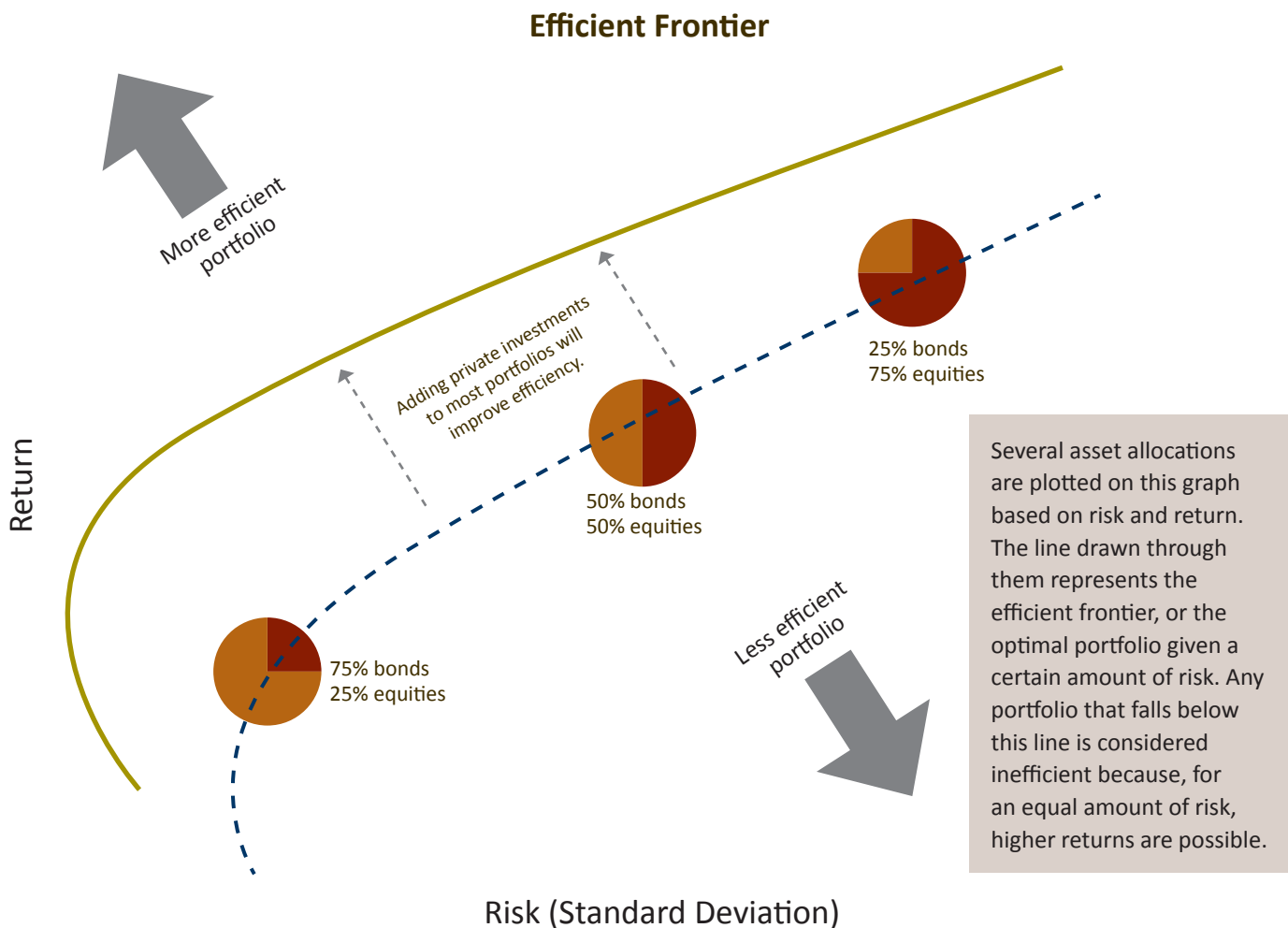
Due to their lack of liquidity, it is common for private investment returns to be reported using one or both of the following methods:

- Multiple =  $\frac{\text{Current Capital Account Value} + \text{Distributions}}{\text{Capital Called}}$
- Internal rate of return (IRR) — The IRR is a somewhat complex formula that is useful in gauging the relative performance of one or more private investments. However, investors should be wary of certain mathematical limitations and pitfalls, and should consult an advisor before relying on it as the sole measure of performance.

### Increased diversification

The fair value of private investments is not expected to move in tandem with the market value of publicly traded equity or debt markets, allowing them to improve the expected risk-adjusted return of most portfolios. Figure 6 shows the potential improvements to portfolio efficiency when private investments are added to a portfolio.

Figure 6: Improves Risk/Return Efficiency



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Investors commonly diversify their private investments by spreading their initial commitments out over a number of different “vintage” years. This type of diversification suggests that investors should consider private investing to be a long-term program, and allow three to six years to reach their target asset allocation.

### Risks associated with private investing

As with any investment, there are risks associated with private investing:

*Due diligence* — The due diligence process for private investments is critically important and expensive, leading most investors to rely on a trusted third party with specific expertise in the space. Steps include:

- Screening and narrowing the large universe of available investments down to a feasible opportunity set.
- Vetting the management teams.
- Determining the fund’s potential economic value and fit within an investment portfolio.
- Reviewing the private placement memorandum, which describes the terms of the partnership. Each PPM is likely to have unique terms, features, and language. Qualified professionals should fully review the documents.

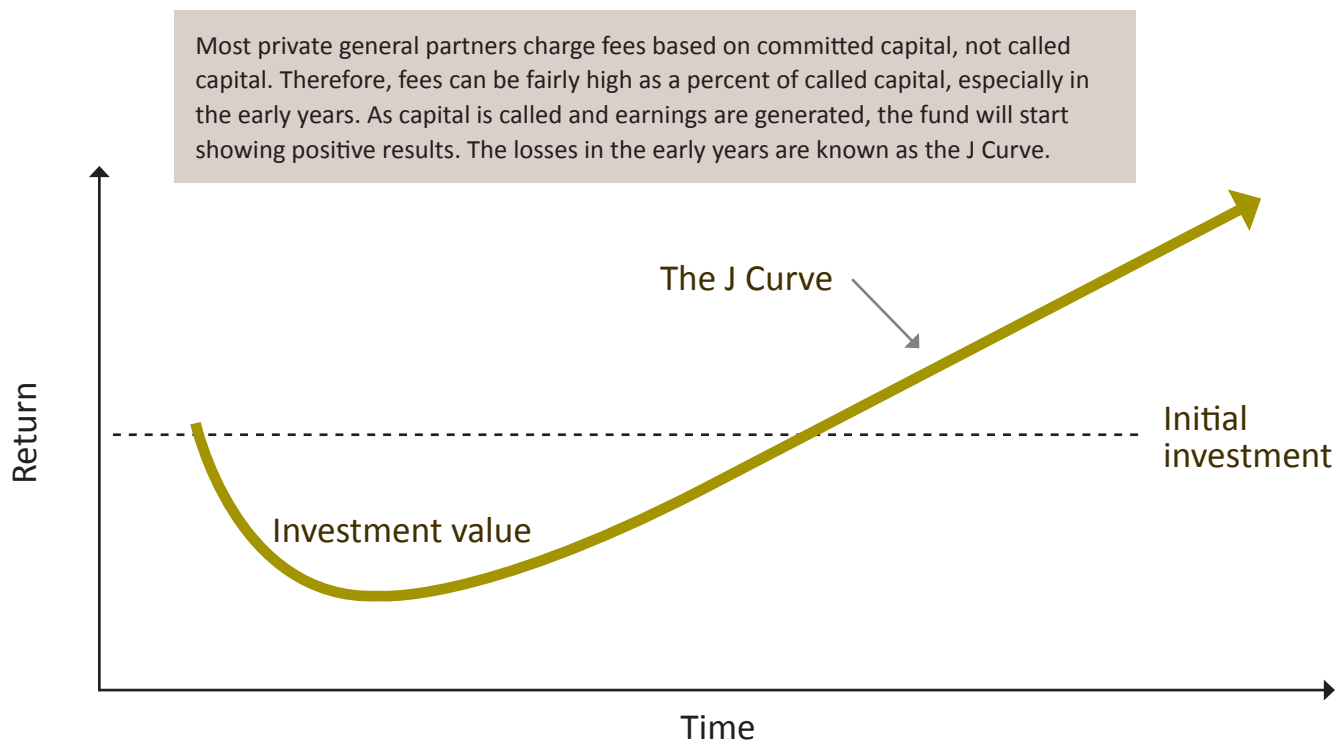
*Alignment of interests* — The most common way to ensure that the GP’s interests are aligned with the LP’s interests is to have the GP invest a significant amount of personal money into the fund.

*Illiquidity* — There are few secondary markets for private investments. Therefore, an investor’s ability to react to potential and actual problems is limited. The illiquidity of most private investment structures should be seriously considered prior to investment.

*Leverage* — GPs may have the option to employ leverage at the project level and/or the fund level. Leverage may magnify actual gains and losses.

*The J Curve* — Most GPs charge fees based on committed capital, not called capital. Therefore, fees can be fairly high as a percent of called capital in the early years. As funds are called and earnings are generated, the fund will start showing positive results. We can illustrate the losses in the early years with the J Curve, which you can see in Figure 7.

Figure 7: The J Curve



Source: CAIA, Level II, Advanced Core Topics in Alternative Investments (2009, Chartered Alternative Investment Analyst Association)

## How we can help

There are many asset categories clamoring for the attention of individual and institutional investors, but not all are equally compelling. As discussed in this paper, private investments have unique characteristics and present both risks and opportunities not readily available in publicly traded investments. Consult a professional with significant experience in this space as a first step in exploring the potential rewards of private investments.

## Author

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