

PRIVATE EQUITY PRIMER

Dow Jones Private Equity Interactive

Leveraged buyouts

Leveraged buyout firms specialize in helping entrepreneurs to finance the purchase of established companies. The approach of such firms is to provide a management team with enough equity to make a small down payment on the purchase of a business, and then to pay the rest of the purchase price with borrowed money. The assets of the company are used as collateral for the loans, and the cash flow of the company is used to pay off the debt. Because the acquired company itself is paying the freight for its own acquisition, these investments were originally known as "boot-strap" deals. Eventually they became known as leveraged buyouts, or management buyouts.

The LBO business has changed dramatically since the buy-and-bust days of the 1980s. Largely because companies today are so highly priced, the buy-and-bust approach rarely works anymore. In addition, banks and other lenders today are much more conservative about lending money for leveraged buyouts.

As a result, buyouts today are financed with more equity. And the companies acquired are usually divisions being sold by corporations that are refocusing on their core businesses, or businesses owned by families who wish to cash out. To earn an attractive return on their investment, LBO firms today must build value in the companies they acquire. Typically, they do this by improving the acquired company's profitability, growing the acquired company's sales, purchasing related businesses and combining the pieces to make a bigger company, or some combination of those techniques. One of those most popular techniques these days is the consolidation, or "buy-and-build."

The consolidation is the polar opposite of the buy-and-bust. It involves not the breaking up of large companies, but the merging of small ones into an organization that, in theory at least, equals more than the sum of its parts. Buyout firms pursuing consolidations have any number of ways of increasing their returns--through leverage, through cost-cutting measures, and through internal growth. They also can benefit from the fact that small companies, because they attract fewer potential buyers, generally command lower purchase multiples than large companies. Consolidators can therefore pay low multiples of cash flow on the companies they buy, but sell the large company they create at high multiples--depending, of course, on market conditions.

An estimated 450 LBO firms ply their trade in the United States today. In 1999, 112 of them raised \$39 billion for fresh investments, down 32 percent from the record 117 firms raising \$57 billion the year before. The decrease in part reflected surging interest among individual and institutional investors in venture capital firms, which enjoyed a huge fund-raising year. It also reflected the fact that many of the larger buyout funds had raised funds in 1997 and 1998, and simply had not yet used up that capital.

Venture Capital

Risk capital for starting, expanding and acquiring companies is critical for any economy to grow. During most of the history of the United States, the market for arranging such financing was fairly informal, relying primarily on the resources of wealthy families. But, after the Second World War, the system started to change. Specialized investment management firms began to be formed with the specific purpose of financing start-up companies that entrepreneurs were launching.

Two of the earliest such firms were Boston-based American Research & Development Corp and Connecticut-based J.H. Whitney & Co. ARD's best-known investment was the start-up financing it provided in 1958 for computer maker Digital Equipment Corp. One of J.H. Whitney's seminal investments was financing that helped to transform a military technology intended to provide a nutritious beverage for troops in the field into a product that today is a household name: Minute Maid Orange Juice.

The number of such specialized investment firms, eventually to be called venture capital firms, began to boom in the late 1950s. The growth was aided in large part by the creation in 1958 of the federal Small Business Investment Company program. SBICs are federally licensed venture capital firms that can borrow money with a government guarantee of repayment. That guarantee allows SBICs to raise money inexpensively. They must then invest the money in entrepreneurial companies. Hundreds of SBICs were formed in the 1960s, and many remain in operation today. They have been surpassed in number, however, by more than a thousand independent private venture capital companies that don't rely on government support.

During the 1960s and 1970s, venture capital firms focused their investment activity primarily on starting and expanding companies. More often than not, these companies were exploiting breakthroughs in electronic, medical or data-processing technology. Early successes include, for example, Intel Corp., Apple Computer Corp., Lotus Development Corp., Genentech Corp. and Federal Express Corp. As a result, venture capital came to be almost synonymous with technology finance.

Today, an estimated 900 venture capital firms in the United States raise outside capital from individual and institutional investors to finance their activities. Most are quite specialized, often investing in a single field, such as telecommunications or health care, and often only in one section of the country, such as the San Francisco Bay area, or Texas.

Venture capital firms also tend to specialize by stage of investing. There are no hard and fast definitions for these stages. Roughly speaking, however, seed-stage firms tend to provide a few hundred thousand dollars, and perhaps some office space, to an entrepreneur who needs to flesh out a business plan. Early-stage investors back companies at a point where they have a completed business plan, at least part of a management team in place, and perhaps a working prototype. Late stage-round investors typically provide a second or third-round of financing, often of \$10 million or more, that funds production, sales and marketing, and carries the company into the revenue-producing stage. Mezzanine, or pre-IPO-stage, investors provide a final round of financing that helps carry the company to an initial public offering.

The advent of the Internet as a new medium for both personal and business communications and commerce created an avalanche of opportunities for venture capitalists in the mid- and late-1990s. As a result, the industry has experienced extraordinary growth in the past few years, both in the number of firms, and in the amount of capital they have raised. In 1999, for example, 186 venture firms raised \$35.6 billion for new investments. That was way up from the 161 that raised \$19.0 billion the year before. Individual and institutional investors have flocked to venture capital funds as returns have skyrocketed beyond those available in other asset classes.

Mezzanine debt/distressed debt

The mezzanine debt and distressed debt specialties of private equity share characteristics of both private debt and private equity financing.

Just as mezzanine seating is in the middle balcony of a theater, mezzanine debt firms provide a middle level of financing in leveraged buyouts—below the senior debt layer and above the equity layer. A typical mezzanine investment includes a loan to the borrower, in addition to the borrower's issuance of equity in the form of warrants, common stock, preferred stock, or some other equity investment. Often, the loan is contractually subordinated to a loan made by one or more senior secured lending institutions. Typically, the note evidencing the loan has a maturity of between six and 10 years, with interest paid only during the first five years. Because the loan is subordinated, the interest rate is generally higher than the rate on the senior debt, and a limited amount of equity is issued to the mezzanine investor for nominal consideration.

Mezzanine investments have been used extensively to help fund the purchase and recapitalization of private, middle-market companies. Mezzanine investors also invest in smaller public companies and in foreign entities. Often, the borrower is highly leveraged after the investment is made.

Because mezzanine investments include both debt and equity portions, mezzanine investors have defied the traditional classifications of lenders, on the one hand, and equity investors, on the other. The flexible nature permits a mezzanine investor to emphasize the capital preservation and current-pay features of a loan and, at the same time, seek significant upside on its investment through the equity participation.

It is the combination of the two features which form the economic rationale for the investment, and which justifies investor involvement in the mezzanine market. The subordination of the loan creates risk that cannot be compensated solely by the coupon on the debt. The equity portion should provide enough upside potential to make the mezzanine investment attractive to the investor. The mezzanine investor has determined not to take equity risk, otherwise it would buy only equity securities and price the investment for an equity return.

Distressed debt firms, as their name implies, buy corporate bonds of companies that have either filed for bankruptcy or appear likely to do so in the near future. Their penchant for seeking out highly troubled companies has led some in the financial press to refer to them as "vulture capitalists." The unflattering metaphor only goes so far, however. Distressed debt firms do, of course, sniff out the sick and weak. But they generally have no taste for carrion. They make their highest returns not by liquidating a company, but by nursing it back to health.

The strategy of distressed debt firms involves first becoming a major creditor of the target company by snapping up the company's bonds at pennies on the dollar. This gives them the leverage they need to call most of the shots during either the reorganization, or the liquidation, of the company.

In the event of a liquidation, distressed debt firms, by standing ahead of the equity holders in the line to be repaid, often recover all of their money, if not a healthy return on their investment. Usually, however, the more desirable outcome is a reorganization that allows the company to emerge from bankruptcy protection. As part of these reorganizations, distressed debt firms often forgive the debt obligations of the company, in return for enough equity in the company to compensate them. (This strategy explains why distressed debt firms are considered to be private equity firms.)

Unburdened of the interest payments on the forgiven debt, the company becomes better positioned to rejuvenate itself. In addition, distressed debt firms typically employ people expert in effecting "workouts," or company turnarounds. When the newly healthy company is later sold or taken public, distressed debt firms stand to profit handsomely from cashing out their equity positions.

Both mezzanine debt and distressed debt strategies are far less common than leveraged buyout and venture capital investing. In 1999, 13 independent mezzanine firms raised \$4.3 billion, up from 12 firms raising \$2.8 billion the year before. Just eight distressed debt firms raised \$4.2 billion in 1999, up from five firms raising \$2.1 billion the prior year.

Funds of funds

For any number of reasons, investing directly in private equity funds can be difficult-particularly for individual investors and small institutional investors.

Information about the performance of private equity managers is hard to come by. Gaining access to what are perceived to be the top-performing venture capital and buyout funds is problematic, since the fund managers often have more demand for their funds than they can accommodate. Finally, the relatively high investment minimums that fund managers generally require--\$20 million isn't uncommon for a large buyout fund-make it challenging for a small institutional or high-net-worth investor to gain sufficient diversification.

For these and other reasons, private equity funds of funds have grown rapidly in popularity during the past few years. The fund of fund manager co-mingles the investments of many small investors into a single pool, then uses it to assemble a portfolio of private equity funds. The minimum commitment to a fund of funds for individual investors is often in the \$250,000 to \$500,000 range—a single, manageable investment that gives investors an instantly diversified set of private equity investments. As the fund of funds industry has matured, managers have begun creating more specialized investment pools that provide investors with more targeted exposure—say, for example, to a portfolio of venture capital funds. For this reason, even many large institutional investors have found the fund of funds to be a useful vehicle for giving them additional exposure to areas of private equity in which they have been under-weighted.

The main drawback of investing in a fund of funds is the added layer of fees. Fund of fund managers generally charge in the neighborhood of a 1 percent annual fee for their services. Many also take a small carried interest, or share of profits, in the 5 percent to 10 percent range. This layer of fees is in addition to the management fees (typically 1.5 percent to 2.5 percent) and carried interest (typically 20 percent to 30 percent) charged by the underlying fund managers.

Private equity funds of funds have been in existence for more than 20 years, but the past three years have seen a sudden surge in their numbers and capital under management. In 1999, 43 fund of fund managers raised \$14.9 billion. That tally represented a 33.7 percent jump from the \$11.1 billion raised by 39 managers the year before.

Secondary Purchases

Private equity investments are generally considered illiquid. There are no public stock exchanges, as there are for publicly-traded securities, on which to buy and sell interests in private equity funds. However, a small secondary market for these interests has developed over the years, giving investors the chance to sell if they desire to. This, in turn, has led to the creation of additional investment opportunities for individual and institutional investors.

A small group of private equity firms specialize in purchasing secondary interests in private equity partnership interests. Managers of secondary funds are not altogether different from those of funds of funds. They don't generally invest directly in companies, but rather in the private equity funds managed by buyout firms or venture capital firms. The big difference is that they are buying their interests in a fund after the fund has been at least partially deployed in underlying portfolio companies. So unlike fund of fund managers, which generally invest in blind pools, secondary buyers can evaluate the underlying companies that they are indirectly investing in.

The secondary market remains a relatively small part of the private equity world. Five firms raised \$1.6 billion exclusively for secondary purchases in 1999, compared with four firms that raised \$2.0 billion the year before. However, as mentioned, investors in funds of funds often gain exposure to the secondary market; fund of fund managers that have secondary allocations generally set those allocations at up to 20 percent.

Commonly asked questions about private equity

How are private equity funds structured?

Private equity funds typically are structured as private limited partnerships. The individual managers of a fund make up the general partner. The providers of capital—the individual and institutional investors—are the limited partners. Elaborately detailed private equity partnership agreements signed by the parties involved govern the actions, and carve out the roles, of both the general and limited partners. For example, most partnership agreements allow for the general partner to draw down capital as needed for individual investments, rather than establishing a fixed timetable for draw-downs. Agreements typically provide for an investment period of five to seven years, and for a partnership term of 10 to 12 years, at the end of which any remaining holdings in the portfolio are liquidated, and the cash and stock are distributed to the limited partners.

How do investments in private equity funds differ from those in public securities?

The main difference is that private equity investments are illiquid. Limited partners in a private equity fund agree to make their capital commitments available for draw-downs by the general partner over a period of five to seven years. There is no public exchange for the trading of limited partnership interests. Although some firms specialize in buying secondary interests in limited partnerships, such firms generally demand an illiquidity discount that cuts into the returns of the seller. Depending on how skillfully the general partner invests, limited partners begin receiving cash or stock distributions a few years into the life of a partnership. They generally won't receive their final distributions until the last years of what typically is a 10-year partnership term.

How are fund managers compensated?

The general partner has two main sources of income. One is the annual management fee, which is calculated as a percentage of total capital commitments to the fund—generally in the 1.5 percent to 2.5 percent range. The second is the carried interest, or share of profits. Traditionally, the carried interest has been 20 percent. However, in recent years, several top-performing venture capital firms have raised their carried interests to 25 percent, or even 30 percent. In some cases, the general partner will guarantee a minimum internal rate of return to the limited partners before sharing in profits. This is referred to as a preferred return. The preferred return is a far more common feature of buyout funds than it is of venture capital funds.

Why do institutional and wealthy individual investors generally allocate a portion of their portfolios to alternative assets such as private equity?

Private equity is considered to be a high-risk, high-return asset class that, in moderation, can enhance the overall return of a well-diversified investment portfolio. Studies also have shown that private equity returns don't correlate closely with returns from other asset classes, such as bonds and public equities. Having an allocation to private equity therefore can help smooth out the returns of a balanced portfolio. Institutional investors generally set target allocations to private equity of anywhere from 1 percent to 25 percent, depending on their appetite for risk and their need for liquidity.

What are the minimum requirements to invest in a private equity fund?

The minimum commitments that private equity firms set for their funds generally run from \$1 million to \$25 million or more. Typically, they range from \$5 million to \$10 million. Fund of fund managers generally set minimum commitments in the \$250,000 to \$500,000 range for individuals, and significantly higher for institutions. At their discretion, general partners can make exceptions to these minimum commitments, and they often do. Amendments made in 1996 to The Investment Company Act of 1940 give private equity firms an incentive to accept individual investors if they have investable assets of \$5 million or more, and institutional investors if they have investable assets of \$25 million. The incentive is that private equity firms can accept up to 499 so-called "qualified investors" as limited partners in their partnerships; otherwise, they can accept a maximum of 99 limited partners. Under Regulation D of the Securities and Exchange Commission's rules, which govern the private placement of funds, private equity firms under most circumstances can't have more than 35 unaccredited investors as limited partners. To be accredited, an individual investor must have a net worth of \$1 million (or joint net worth with spouse), or have made at least \$200,000 in each of the prior two years (or joint income with spouse of at least \$300,000), and have a reasonable expectation of making at least the same amount the next year.