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A Private Equity Primer: Why and How to Invest in PE

Arnerich Massena, Inc.

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The return potential is the beacon that draws investors to private equity; the asset class has outperformed all other asset classes over long time periods. In addition to returns, many private equity investors experience a sense of fulfillment and satisfaction knowing that their investment dollars contribute to and directly impact economic development and growth. The allure of being in the groundswell of new ideas can be a powerful attraction for the asset class. Before you invest in this asset class, it is important to understand how private equity works. In this paper, we provide the basic information needed to make an educated decision on whether or not private equity is right for you.

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A Private Equity Primer: Why and How to Invest in PE

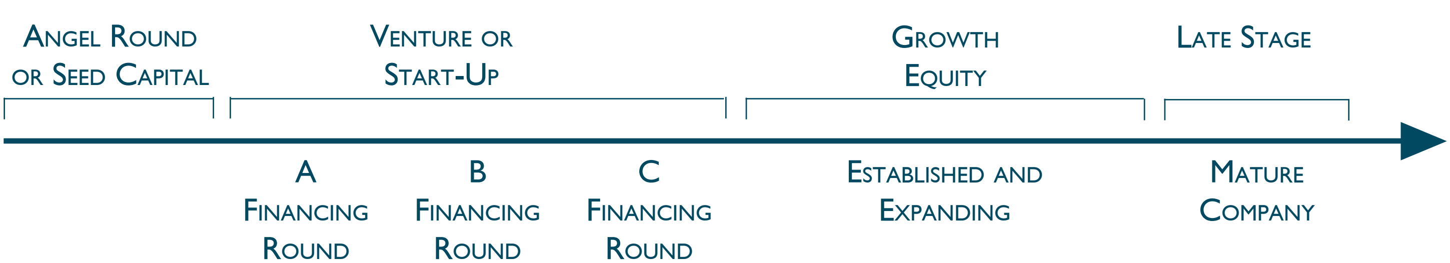
Most investors are familiar with and feel comfortable investing in publicly traded stocks. You purchase shares of ownership in a company with the hope that increased demand for the company's product or service increases the value of your stock over time, allowing you to sell the stock for more than your purchase price. You can invest in small companies, large companies, start-ups or mature businesses, in the U.S. or internationally. Private equity investing is fundamentally the same: investors also purchase ownership interests in a company, seeking to invest in businesses that grow in value over the life of their investment. Private equity covers the same spectrum of small and large, new and mature, domestic and international. Both types of investing are subject to individual company fluctuations and larger market forces.

Indeed, other than the way the investments are structured (private offering versus public offering), there are many similarities between investing in public equity and investing in private equity. However, one of the most significant differences is in liquidity; whereas public stock investments are liquid, with the prices quoted daily in public markets, private equity investments may have long periods with little or no liquidity. So why do investors choose private equity?

The return potential is the beacon that draws investors to private equity; the asset class has outperformed all other asset classes over long time periods. In addition to returns, many private equity investors experience a sense of fulfillment and satisfaction knowing that their investment dollars contribute to and directly impact economic development and growth. An investment in private equity may play a significant role in developing a company from a start-up into a profitable venture, or perhaps expand an existing small business. The allure of being in the groundswell of new ideas can be a powerful attraction as well.

However, before you invest in this asset class, it is important to understand how private equity works. In this paper, we provide the basic information needed to make an educated decision on whether or not private equity is right for you. This primer provides a guide to the what, why, and how of private equity investing.

Potential funding cycle of a private company



What is private equity?

As with any type of investing, the keys to success are understanding the asset class and carefully choosing investment managers.

For most investors, owning stock means owning an interest in companies that are listed on a public stock exchange. Anyone can purchase stock in a publicly traded company and subsequently sell the stock. In private equity investing, the investor is similarly purchasing an ownership interest (usually stock), but the interests are only sold or offered in a private market to sophisticated investors who meet certain criteria under U.S. securities laws (including the "accredited investor" and/or "qualified purchaser" definitions under the Securities Act of 1933 and Investment Company Act of 1940, respectively). The ownership interests are generally illiquid, as their sale and resale are significantly restricted under the securities law.

The term "private equity" is a broad term. It encompasses investment in companies at various stages of their lifecycle, from start-up companies that are not much more than an idea to established large companies that are looking to expand and grow.

The primary risk of investing in private equity is the same as in public equity investing — the risk that the value of your shares will decrease. However, in private equity, that risk may be heightened because there is less certainty. Private equity is an illiquid asset class, and capital is generally tied up for extended lengths of time. Experienced private equity investors are willing to accept this level of risk for potentially higher return potential.

As with any type of investing, the keys to success are understanding the asset class and carefully choosing investment managers.

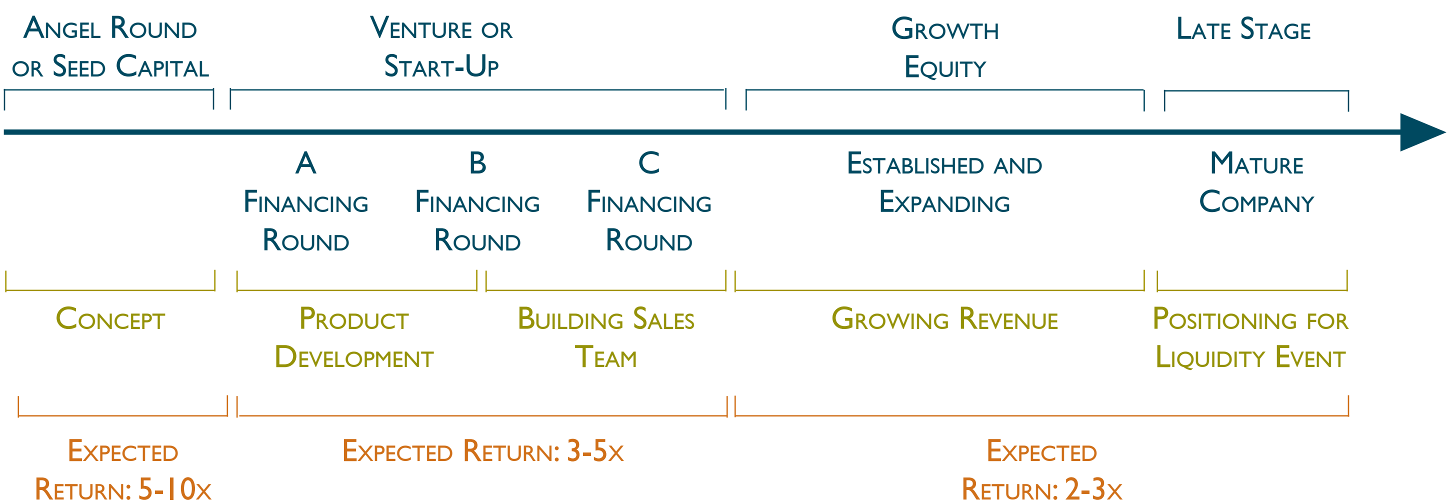
Lifecycle of a company

To understand direct private equity investing, it is helpful to look at the stages a developing company will typically experience over the course of its lifetime. Each stage is often accompanied by at least one round of financing, and each round is an opportunity to invest in the company. The following timeline illustrates the traditional stages a company generally experiences, though the distinctions between one stage and the next are not always clearly defined. Individual companies may follow different trajectories or experience these stages differently.

Angel round or seed capital

Every company begins with an idea. Someone or a group of people have a concept of a product or service they believe is marketable and has the potential to be profitable. To turn that idea into a company requires initial

Figure 1: Potential Funding Cycle of a Private Company



capital, if only to support the individual or group so that they can focus on developing the idea into something concrete. The term "angel round" refers to the "angel investors," often family and friends, who help to finance the company early on. This stage is also sometimes referred to as the "seed round," in which the company seeks capital necessary to get the idea off the ground. Typically, even for this first round of seed capital financing, the company-to-be must show a proof of concept that demonstrates the viability of the idea.

Because the risks are amplified in the angel round, investors should expect to be highly compensated for their investment; a five to ten times return of investment is not unreasonable, given the high potential for failure. It is important to point out that in order to have this level of return expectation, the seed investor typically must participate in all financing rounds throughout the life of the company, until the company is merged, sold, or registers its shares for sale on a public stock market (an IPO). However, many angel investors are unable to continue to support the company financially as it grows and suffer the effects of dilution (where their ownership percentage decreases due to the issuance of new ownership interests in subsequent investment rounds), or find that they need to sell their shares on the private market (usually at a significant discount) before being able to realize the highest potential return from their investment.

Venture or start-up

In its next stage, a company may be labeled as an early stage, start-up, or venture company. The company exists and has a workable concept, but needs capital to develop its product or service and get it to market. "Venture capital" refers to private equity investment at this stage. Several rounds of financing may occur within the venture stage, generally designated as financing rounds A, B, and C. The "A" round is often when institutional capital enters for the first time, and may be used to develop the business and product to the point of accumulating customers. By the "C" round of financing, also called the commercial round, the company should have a customer base, be earning a revenue stream, and be building out their sales team. At the venture stage and the next growth equity stage, the risks are not quite as pronounced as in the seed stage, but are still significantly elevated. Private equity investors who invest in venture capital and continue investing through the company's subsequent financing rounds until a monetization event occurs can typically expect returns in the range of three to five times the initial investment.

Growth equity

Once a company reaches the middle market stage — when the product or service is successfully selling to customers — the next step is to raise capital to fund growth efforts. This round of financing is referred to as growth equity or mezzanine-level financing. This stage can offer a very attractive return potential. Many investors are interested in entering the private equity market at the growth equity stage; their investment can help a company expand and grow its clientele, building on an already-established foundation. As with the venture stage, this stage may involve multiple rounds of fundraising and financing. The expected return for investors entering at the growth equity stage is usually around two to three times the initial investment.

Late-stage/buyout

Late-stage financing refers to the capital needed to help a company prepare and position for a liquidity event. The risks at this stage are lower, since the company is already established and successful. The expected return is typically two to three times the initial investment (with embedded leverage).

Another private equity opportunity with a mature, established company is to participate in a private fundraising transaction for a publicly traded company. This type of transaction is referred to as a "PIPE" transaction — Private Investment in Public Equity. With PIPE financing, shares of a public company are offered to private investors (as opposed to being offered on a public exchange). PIPE deals often provide a discount to investors, offering shares at a price that is below the company's public market value in order to secure financing that the company may not otherwise be able to publicly raise within a needed timeframe. PIPE financings can often be more efficient in terms of time and cost for the company and are often more liquid than other private equity investments, since investors may be able to sell their shares into the public market (shares are "restricted securities" that cannot be sold or traded publicly until the issuer files a registration statement with the SEC to provide for public resale, usually after a certain period of time).

Monetization/exits

For private equity investors, the exit is the key point — also called the liquidity event — where returns are realized. There are several different ways an exit can be accomplished.

Financial exit:

- Initial Public Offering (IPO): the company's initial offer of its equity interests to the public through a listing on a public exchange — part of all the private equity investors' shares may be sold in the IPO or after an initial holding period.

Liquidity event or strategic exit:

- Sale: the company is sold and investors earn a proportionate share of the proceeds.
- Buyout/acquisition: the company is acquired by another company, which purchases the shares directly from investors in return for cash or stock in the acquiring company, or a combination of both. If the acquiring company is a publicly traded company, its stock may be subsequently sold.
- Company buy-back: the company purchases the shares back from investors.

While these liquidity events are most often the source of return for private equity investors, there is a vibrant secondary market for investors who wish to gain liquidity out of their investment before a liquidity event. However, selling shares on the secondary market usually means selling at a steep discount, depending on the market environment at the time and a number of company-specific factors.

Investing in private equity

As you can see from the previous section, there are multiple stages at which a private equity investor may choose to invest. Private equity funds sometimes define their investment styles by the stage of development of the companies in which they invest. Venture capitalists prefer the start-up stage of companies. Because they are "in on the ground floor," the high potential for return is alluring. On the other hand, there is a high risk of failure among start-up companies. There are also private equity investors who invest only in late-stage, buyout companies; working with mature firms that have steady cash flow can mean lower risk. And there are plenty of middle-market private equity investors focusing on the expansion stages of companies, as well as funds and investors who diversify among multiple stages of companies.

PRIVATE EQUITY FINANCING CAN BE A WIN-WIN-WIN SITUATION, SERVING MULTIPLE PARTIES IN DIFFERENT WAYS AND FULFILLING A VARIETY OF ECONOMIC FUCTIONS.

Benefits

Private equity financing can be a win-win-win situation, serving multiple parties in different ways and fulfilling a variety of economic functions.

- Win: It provides a pathway whereby entrepreneurs can bring their best ideas to the market, making them a reality.

Table 1: U.S. Private Equity Index Performance (as of Sept. 30, 2013)

Index	1-year	3-year	5-year	10-year	15-year	20-year	25-year
Cambridge Associates LLC U.S. Private Equity Index®[1]	**17.19**	**15.66**	**10.95**	**14.21**	**12.02**	**13.49**	**13.39**
S&P 500 Index	19.34	16.27	10.02	7.57	5.33	8.80	9.96

Source: Cambridge Associates LLC
The Cambridge Associates LLC U.S. Private Equity Index® is an end-to-end calculation based on data compiled from 1,096 U.S. private equity funds (buyout, growth equity, private equity energy, and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2013.
[1] Pooled end-to-end return, net of fees, expenses, and carried interest.

Figure 2: Growth of $1,000,000 over ten years

If you invested $1,000,000, at an annual rate of return of 14.21% (the Cambridge Private Equity Index's 10-year return), your account would grow to $4,106,800 after ten years. At the S&P's 10-year return of 7.57% annualized, the same $1,000,000 would grow to $2,126,808.

For illustrative purposes only. Figure 2 assumes a $1,000,000 initial investment and a 10-year investment period with an annual return of 14.21% and 7.57% respectively. Returns are shown as an approximation of an investment in private equity compared to the performance of the S&P 500 over a 10-year period ending 9/30/2013. An investor's actual experience in investing in private equity over this time period may materially differ. Past performance is no guarantee of future returns.

- Win: Experienced business people have an opportunity to spend their know-how on worthwhile ventures and provide fledgling entrepreneurs with some of the expertise, connections, and business acumen that they may be lacking.
- Win: Investors have the opportunity to support growing businesses and draw value from their great potential.

The table on the previous page shows U.S. private equity benchmark performance versus the S&P 500 Index. Over the long term (ten years and longer), private equity has outperformed the benchmark by a significant margin. In Figure 2, you can see how the ten-year return can translate into growth of an investment. Private equity offers investors meaningful potential for outsized returns.

Investing in private equity also provides investors with access to markets and niches that public equity may not reach. For instance, private equity investors may gain access to highly focused growth companies or participate in early ownership of new technologies.

Risks

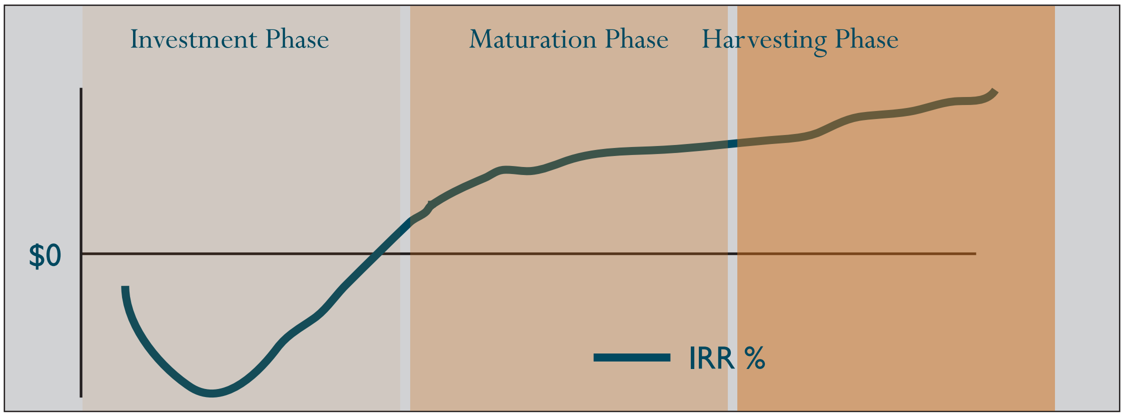
Superior return potential is not without risk. Investing in private equity funds involves some risks particular to the asset class.

Illiquidity: Private equity investing involves commitment of capital for long periods of time, requiring patience. Growing businesses need guaranteed capital they can count on. While there is a secondary market for selling private equity interests, sales are restricted under U.S. securities laws and generally involve a steep discount.

The "J-curve": Initial fees and early write-offs result in what is typically called the "J-curve," a phenomenon in which the value of a private equity fund investment may drop in the beginning. Early returns are very often in negative territory, which can be alarming for inexperienced investors. Experienced private equity investors, however, are familiar with the "J-curve" and a fund's ability to increase in value and deliver returns once it begins to mature. This return pattern, shaped like a J (as shown on the following page) is common in private equity funds and is expected.

Concentration: When an individual invests in a bond fund, that fund likely holds hundreds of different bonds. Stock funds can hold many different stocks. Private equity funds, however, generally invest in only a handful of companies at any given time (5-15 companies is typical). This concentration heightens the risk in a private equity portfolio, since each company will have a significant impact on the performance of the fund. There are private equity funds of funds, which provide a way to mitigate this concentration risk; we'll discuss methods for private equity investing next.

Figure 3: J-Curve



For illustrative purposes only; this is a hypothetical example.

How to invest in private equity

Investors wishing to add private equity to their portfolios have several options. They include: direct investment, investment in a private equity fund, and investing in a private equity fund of funds.

Direct private equity investment

Direct private equity investment is exactly what it sounds like — investors provide capital directly to a private company. Only certain types of investors can invest in private equity (accredited investors and qualified purchasers), and it typically requires significant capital to meet minimum investment requirements. This method of investment is for experienced private equity investors or investors who have guidance. Direct private equity investors often prefer to be quite hands-on with the company in which they invest, participating directly in the management and development of the company. Concentration risk is an issue with direct private equity investment.

Direct private equity investors need to think ahead. Most successful companies go through multiple rounds of financing and require significant time to grow. Investors need to be patient and maintain a long-term outlook. Most importantly, they need to have a commitment mentality, with the willingness to stick with the company as it goes through its growing pains. This includes the willingness to continue to participate in subsequent investment rounds to preserve one's interest and prevent dilution.

Private equity funds

Private equity funds typically hold a handful of diversified businesses. Some funds are focused on a particular lifecycle stage, whereas others diversify, investing in companies that are in different stages of their lifecycles. Private equity funds may specialize in particular sectors or geographic areas as well.

These funds are usually structured in the form of limited partnerships. The fund manager acts as the general partner, with control over, and liability for, the management of the fund, and private investors become limited partners, sharing in ownership but without management participation.

When you invest in a private equity fund, you commit a certain amount of capital to the fund. When the fund manager identifies an appropriate investment opportunity, you receive a "capital call" — the fund requests a portion of your committed capital for investment. Most private equity funds have a three- to seven-year investment window in which to invest committed capital. Some funds charge fees only on invested capital, whereas others charge fees based on committed capital; it is important to understand how your private equity fund charges fees before developing your commitment strategy (to be discussed shortly).

Private equity funds of funds

A private equity fund of funds is another option for private equity investors. A fund of funds is structured similarly to a private equity fund, but instead of investing in individual private companies, the fund manager selects multiple private equity fund managers in which to commit capital, often providing investors with access to superior managers to whom they might not otherwise have access. Through a fund of funds, a private equity investor may be diversified across a large number of companies. Funds of funds might diversify by the number of companies held by each fund manager, vintage year (the year in which the fund makes its first investment), lifecycle stage, industry or market sector, and/or geography. However, this additional level of risk management, access, and diversification adds another layer of fees.

Commitment strategy

The timing of investment of committed capital is unpredictable, as is the return of capital and realization of profit. When starting a private equity investment program, you should identify a specific dollar amount or percentage of your investment portfolio that you would like to commit to private equity, and expect it to take several years to reach your goal. With any method of private equity investing, building a private equity program requires the development of a commitment strategy; it takes time to build a private equity portfolio. Multiple investment commitments will be necessary to reach and maintain your investment allocation to private equity, as committed capital is actually "called" over a period of time, and not all committed capital may necessarily be called. For this reason, some investors will adopt a strategy of "overcommitment," whereby they commit more capital than they actually want to invest in private equity. This strategy has been widely adopted by private equity investors, and makes sense in normal market conditions. One risk to be aware of, however, is to make sure that you have the assets to meet unexpected capital calls that may exceed your

Table 2: Sample Commitment Strategy

		Capital Called/Dollars Invested										
Total Commitment		Year 1 $	Year 2 $	Year 3 $	Year 4 $	Year 5 $	Year 6 $	Year 7 $	Year 8 $	Year 9 $	Year 10 $	Year 11 $
Year 1	$1,000,000	300,000	700,000	500,000	700,000	1,000,000	850,000	750,000	600,000	400,000	200,000	-
Year 2	$1,000,000		100,000	300,000	500,000	700,000	1,000,000	850,000	750,000	600,000	400,000	200,000
Year 3	$500,000			50,000	150,000	250,000	350,000	500,000	425,000	375,000	300,000	200,000
Year 4	$500,000				50,000	150,000	250,000	350,000	500,000	425,000	375,000	300,000
Year 5	$500,000					50,000	150,000	250,000	350,000	500,000	425,000	375,000
Year 6	$500,000						50,000	150,000	250,000	350,000	500,000	425,000
Year 7	$500,000							50,000	150,000	250,000	350,000	500,000
Year 8	$500,000								50,000	150,000	250,000	350,000
Year 9	$1,000,000									100,000	300,000	500,000
Year 10	$500,000										50,000	150,000
Year 11	$500,000											50,000
Total invested (principal only)		300,000	800,000	850,000	1,400,000	2,150,000	2,650,000	2,900,000	3,075,000	3,150,000	3,150,000	3,050,000

For illustration purposes only

current distributions. Flexibility is important with private equity investing. See Table 2 above for an example of a commitment strategy for an investor who seeks to invest $3,000,000 in private equity and maintain that level of investment over time. Please note that the table does not take into consideration investment appreciation; it is a sample of what a schedule might look like over time.

Fees, benchmarks, and returns

Private equity fee structures

The private equity asset class is unique in terms of fees, benchmarks, and return calculation. While fee structures vary among private equity funds, it is fairly typical for private equity managers to charge two fees: an annual management fee and a carried interest fee, which is a portion of the profits generated from the fund. The often referred to "2 and 20" rule is a fee structure in which investors pay a 2% annual management fee and 20% of net profits upon liquidation. Both the management fee and the carried interest fee vary among managers. Usually, a hurdle or "preferred return" must be achieved before the manager can begin collecting the carried interest fee. The annual management fee, as noted above, may be charged on invested capital or committed capital, or on a combination of the two that changes over time (e.g., a fund may stop charging a management fee on committed capital at the end of the investment period, at which point it earns the fee only on invested capital). Because private equity fees can be complex, it is wise to carefully study a fund's fee structure before investing.

Private equity return calculation

Calculating returns for private equity is complex. Unlike public equity, performance cannot be measured accurately with annualized returns for many reasons. One of the most significant reasons is that a private equity investment's cashflows are subject to severely irregular timing — money is committed at one point but called at a later date, usually in partial increments over an extended period of years. Furthermore, at each call, a private equity fund may or may not invest all of the called capital, creating further dissonance from the performance attributes of public equity. Because of this, a private equity investment's performance is realized over the full life of the investment. For investors, realized returns are only recognized upon liquidity events. While quarterly company valuations provide periodic indicators of a fund's appreciation or depreciation, they may not reflect the ultimate return of the fund (think back to the "J-curve"). As such, several different methods are used to calculate private equity returns.

One of the most common return calculations is the internal rate of return, or IRR, also called the discounted cash flow rate of return. Generally speaking, the higher the IRR, the more desirable the investment. While IRR is the most common performance measurement for private equity because it incorporates the time value of money, IRR cannot be used to compare private equity with public equity asset classes and indexes. Near the end of a fund's life, time-weighted returns tend to approximate the IRR and provide a method whereby private equity returns can be compared with public equity indexes and other asset classes. Time-weighted returns do not measure the effect of timing on performance, which while sensible in public equity markets where managers do not always control the size and timing of investments, is less accurate for private equity investments where the timing of the investment is impactful.

Benchmarking

Benchmarking private equity investments is inherently difficult based on the nature of the asset class return pattern (think "J-curve" again). Private equity investing is a long-term commitment, and evaluating it in terms of short-term returns can be misleading. A minimum of a ten-year time frame is really needed to effectively evaluate a private equity portfolio. On the other hand, investors usually want some way to measure the progress of their private equity investments, particularly against the public equity market. To satisfy this demand, there is an increasing number of companies creating and publishing proprietary private equity benchmarks. While we find that these benchmarks can be quite useful, none of them are ideal, as they all have significant shortcomings (a discussion that is outside the scope of this paper).

The public market equivalent, or PME, is another method of benchmarking private equity. This method compares private equity returns to a public benchmark by giving the benchmark a hypothetical return had the investors' cash flows been invested in the public index rather than the private equity investment. While difficult to produce, this method provides a good sense of the opportunity cost of having invested in private equity versus public equity, and has become more popular over the past few years.

The simplest way to evaluate a private equity portfolio over the long term is to use a public equity market index such as the S&P 500 or MSCI All Country World Index.

Conclusion

Private equity is one of the most misunderstood asset classes. However, we believe that the advantages of private equity are such that taking the time to better understand the asset class and how to invest in it is worthwhile. The potential of the asset class to provide outsized returns makes it very attractive, but the wide range of possible returns means that investment selection is of key importance.

> **To turn a great idea into a profitable company requires committed capital, leadership, and efficient use of capital.**

In order to be successful in investing in private equity, the right ingredients are crucial. To turn a great idea into a profitable company requires committed capital, leadership, and efficient use of capital. Arnerich Massena's extensive experience in selecting high-quality private equity managers has led to successful, diversified, long-term private equity portfolios. Some of the components of a private equity fund that we look for include:

- A focus on the "C" financing through growth equity stages of companies' lifecycles. There is typically greater visibility at this stage than in venture-stage companies, making it possible to achieve a more accurate analysis.
- Niche managers and products that have an opportunity to capture a broad market share.
- Sector specialists and/or regional specialists, i.e. people who are not necessarily private equity experts, but who have great talent and skill in their particular field and know how to implement within a private equity structure.
- A focus on real asset investments such as water, energy, agriculture, etc., because we believe that what we need to survive is a likely area for rapid growth in the current environment.

In private equity portfolios, Arnerich Massena focuses on managing the risks so that clients can take advantage of the benefits the asset class offers. Private equity investing is not for all investors, as it requires commitment, patience, and a tolerance for the particular risks of the asset class. Arnerich Massena believes that learning about private equity is the first step in gaining a familiarity that can develop into the knowledge and comfort level required of a private equity investor.

Glossary

Angel investors: Investors who provide seed or start-up financing for a venture in exchange for equity, also sometimes providing non-cash contributions such as industry contacts and knowledge.

Buyout: The purchase of a company or a controlling portion of its shares.

Capital call: Occurs when a private equity opportunity is ready for investment. Capital is generally "called" in partial amounts from an investor's committed capital over a period of time (often years).

Capital commitment: Each investor (usually a limited partner) "commits" to investing a certain amount in the fund or company over time. Capital is not invested until it is called.

Carry: Also called "carried interest," the carry is the share of the profits that are due to the fund manager after it has returned the cost of investment to investors. Carried interest is typically expressed as a percentage of the fund's total profits.

Closing: When a company reaches its capital target, it will "close" the current round/series. Companies may have several rounds of financing and closing (A, B, C, D) before its final close.

Company buy-back: One form of an exit in which the company purchases back its shares from investors.

Early stage: A developing company that is at a stage where it has a business plan, product, or service but is pre-revenue.

Exit: The private equity exit, also referred to as the liquidity event or realization, is when the investment is realized. The exit can occur through an M&A (merger & acquisition) buyout, a sale, a company buy-back, or an IPO.

Follow-on funding: Private companies often need several rounds of financing over their lifetime. When a private equity firm or investor has already financed a company and provides additional financing at a later stage, this is called follow-on funding.

Fundraising: The process by which private equity firms solicit commitments from investors.

General partner: Private equity investment firms who bring together the limited partners with the private ventures.

Initial Public Offering (IPO): When a privately held company lists a portion of its shares on a public stock exchange, thus "going public." The IPO is an exit opportunity for private equity investors.

Internal Rate of Return (IRR): A performance benchmark for private equity investments.

J-curve: A graphic representation of the typical early negative return during the investment phase of a private equity investment and subsequent slow, but significant, rise as the firm matures.

Later stage: A developing company that is producing revenue and has a developed customer base; private equity investors may provide funding to finance expansion.

Limited partner: Many private equity funds are structures as limited partnerships. The limited partners provide most of the capital for the fund and retain most of the economic benefit, but do not participate in the fund's management or have personal liability for the fund.

Limited partnership: A legal structure used by many private equity fund managers for their investment funds. The manager generally serves as the general partner and investors become limited partners.

Private equity fund: A fund that invests directly in private companies.

Private equity fund of funds: A fund that invests in multiple private equity funds.

Realization: The liquidity event, or exit, in which the investor realizes the gains (or losses) from their private equity investment in a company via a sale, IPO, buyout, or merger.

Secondary offering: An investor who is unable to meet a commitment may sell their interest in a company or private equity fund to a secondary buyer, usually at a steep discount.

Venture: An early-stage developing company, typically at a stage with a business plan, product, or service, but pre-revenue.

Vintage year: The vintage year of a private equity fund is the year in which the fund makes its first investment in a private company.

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