CHAPTER 1

The Private Equity Process

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INTRODUCTION

The institutionalization of private equity is, perhaps, one of the most important advances in the field of modern finance: It is through private equity (PE) that the seeds of new ideas are permitted to germinate and the souls of the withering may be granted rebirth. While the previous expression is perhaps extreme, those intimately connected with the arena would strongly support its assertion.

PE investment is—to put it mildly—a hot issue in today's marketplace. In the past five years alone, investment in the arena has totaled $832 billion,[1] a value roughly equal to the size of Mexico and India's nominal gross domestic products (GDPs), and 40 times larger than the GDP of Kenya. In the United States private equity investment topped $100 billion in 2007 alone, a particularly strong showing in light of the credit market turmoil that curbed 4th quarter investments. (See Exhibit 1.1 for further information.)

Despite the recent woes, PE is garnering more attention and press than ever before as numerous firms continue to raise capital at previously unheard-of levels. Indeed, the top ten largest PE funds in history have all been raised in the past three years.

To understand the PE arena is to understand the "man behind the curtain" in *The Wizard of Oz:* Many details of the

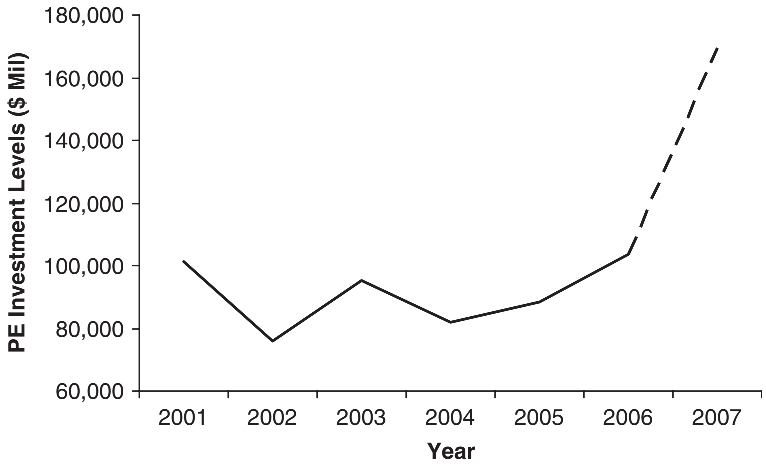

EXHIBIT 1.1 Historical Private Equity Investment Levels

Source: Thomson's *VentureXpert* database.

industry are shrouded in secrecy, and firms are often reluctant to divulge details of their funds to outsiders. However, once understood, the complexities of the industry largely vanish, and the reader is left with a concrete understanding of the motivations that keep such a well-oiled machine running.

Within the PE arena are numerous types of risk capital; however, this book will largely focus on two types of such investments: buyouts and venture capital. Other types of PE investments, including mezzanine financing, private investments in public equity (PIPEs), and fund of funds investments (FoF), will be discussed throughout the work; however, these will not be the primary focus of this text.

Along these lines, this chapter serves to acclimate the reader to common PE terms, while providing a comprehensive introduction to the structure of the industry. Buyout and venture capital funds will be the chapter's primary focus.

We now begin with a general overview of the private equity arena. This section will introduce many PE terms that will be further defined in subsequent sections.

GENERAL TERMS AND BRIEF OVERVIEW

PE funds are companies that are formed and managed by PE firms. These funds are—for the most part—private investment vehicles that permit investors to combine their capital for investment: This practice allows investors to greatly increase their purchasing power in the marketplace. Additionally, PE funds are frequently unregistered investment vehicles, meaning that, unlike publicly traded securities, their investment and financial reporting policies are not governed by the Securities and Exchange Commission (SEC) or another policing body.

Managers of PE funds are often referred to as the general partners (GPs), while the investors are known as the limited partners (LPs), the latter name signifying the limited liability of the investors (i.e., an investor can lose, at most, the sum of their total capital contributions). LPs are often public or private pension funds, banks, insurance companies, or high-net-worth individuals, and they commit specific amounts of capital to PE funds.

The California Public Employees' Retirement System (CalPERS) and The Blackstone Group are prominent examples of limited and general partners, respectively. Furthermore, as is often the case in PE, these two organizations have an intimate relationship with one another, as CalPERS has invested in no less than three of Blackstone's funds since 1999.[2]

The PE fund provides a framework for investors to pool their capital in order to invest in portfolio companies. This investment is done at the discretion of the GPs, to whom the investors entrust their capital. LPs are not able to influence the day-to-day operations of the fund, as doing so may cause them to lose their limited liability status.

Unlike other securities, most PE funds are ephemeral entities; they do not exist in perpetuity, and have a legally bound, limited lifetime; conversely, *evergreen funds*, as their name implies, are not limited-life entities. While a firm may exist for decades, the typical lifetime of a given PE fund is roughly 8 to

12 years. However, in some cases where prospective fund deals may already be scouted, a fund life of 6 years is not uncommon.

It is the GPs' goal to realize all investments prior to the fund's liquidation at the end of this time period. These liquidity events take place as companies are *harvested* by the GPs, usually beginning around the fourth year of the fund. Portfolio companies are *harvested* through many types of exit strategies: an outright sale (to a strategic or financial buyer), an initial public offering (IPO), and merger are three of the most common exit strategies.

As such, private equity investments are rather long-term commitments. Once a company is liquidated, a portion if not all of the profits are distributed to the LPs as compensation for their investment.

Throughout the life of the fund, the LP must adhere to "capital calls" made by the GP, or explicit requests for funds. It is important to note that, while the LPs make funding commitments to the GPs when they first join the fund, their pledged capital is neither immediately taken nor invested: Once the fund's fund-raising stage has closed (typically after 18 months), the GPs require time to scout deals before they begin investing money. In this manner, the general partners often wait until they have located investments before they make formal requests to LPs for pledged capital. However, capital calls need not be event-based: Some funds draw down capital from investors on a pre-specified time schedule. This permits the investor to budget for capital subscriptions with certainty.

On the opposite end of the fund's life is the "disinvestment period." It is during this time that the GPs focus on realizing returns on the fund's assets. Some investments in portfolio companies will pay off handsomely, while others will not. During the "disinvestment period," it is the GPs' job to discern which investments are worthy of follow-on funding and which should be liquidated. This decision is motivated by the fact that PE funds only have a finite lifetime.

Legal terms, such as the lifetime of the firm, are specified in a document called the "limited partnership agreement" (LPA), which, despite its appellation, contractually binds *both* the general and limited partners. The LPA's name refers to the fact that many PE funds are organized as limited partnership companies, as opposed to "C" corporations—or any other structure for that matter. Other terms included in the LPA discuss the investment restrictions placed on the GPs, provisions for extending the fund's lifetime, commitments made by LPs, actions taken should LPs default on their commitment, distribution of fund profits, and GP management fees.

With respect to the lattermost item, the GPs—especially those of buyout funds—typically receive such fees dependent on the size of the fund, although some of today's largest funds continue to charge management fees commensurate with those of lesser size. A standard management fee charged by a GP ranges between 1.25 percent and 3 percent per annum of the fund's committed capital. Larger funds generally will charge investors a smaller management fee representative of the administrative economies of scale associated with running such firms (e.g., less paperwork and staff per dollar committed capital). However, many venture funds charge a standard 2.5% management fee irrespective of the fund size as the economies of scale are considerably less for these funds as for their buyout counterparts.

Buyout funds purchase mature companies with well-known pasts. In contrast, venture funds seek out small, newly-formed companies with promising ideas and strong management teams. While the buyout model permits GPs to acquire larger companies as the fund size grows (e.g., Bell Canada, TXU Corporation, Chrysler), venture partners are committed to investing in smaller firms in spite of their fund size.

In addition to management fees, GPs also receive compensation from what those in the PE arena call the *carried interest,* or, more simply, the *carry*. This term denotes the portion of

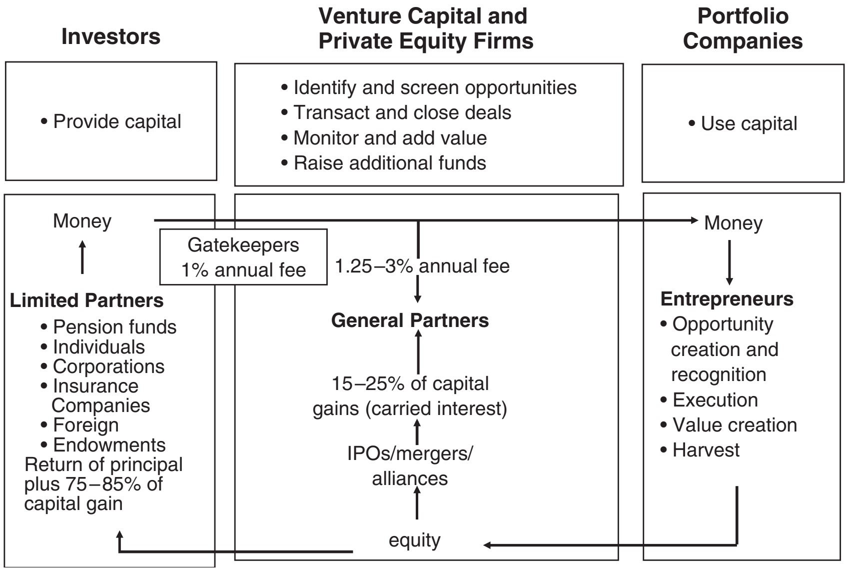

EXHIBIT 1.2 The Private Equity Process

realized fund profits the partners will retain in exchange for managing the fund.

The standard carry used in many PE agreements is 20 percent of the fund's profits, although a carried interest of between 15 and 25 percent is not uncommon. This compensation also serves to align the interests of the GPs with those of the LPs, as it incentivizes the GPs to generate strong investment returns above and beyond their usual management fees. Exhibit 1.2 presents a diagram of the complete private equity process.

Carried interest has caused quite a stir in recent months as members of Congress have denounced the current practice of taxing carried interest as capital gains (with a maximum federal rate of 15% in 2007), rather than as ordinary income (with a maximum federal rate of 35% in 2007). In doing so, private equity investors (save those that are tax-free entities) may save as much as 20 percent on their income tax bill for the gains associated with these investments.

UNDERSTANDING PRIVATE EQUITY

Private Equity Firm Structure

At the crux of the *private equity* arena are a number of PE firms who are largely responsible for raising capital for investment: The Blackstone Group, Kohlberg Kravis Roberts & Company (aka KKR), and Texas Pacific Group are three such firms at the center of this industry. When compared with the total size of the companies that they oversee, these firms are extremely small. For instance, The Blackstone Group has a staff of only 60 managing directors and approximately 340 ''other investment and advisory professionals'' who manage their investments. This group of professionals oversees an immense portfolio with total assets under management of over $88 billion for the company.[3] Smaller firms will often have significantly fewer personnel: A firm with assets totaling $250 million may have a staff of only 20 to 40 employees.

However, despite their relatively small size, many private equity firms are now outsourcing duties once performed in-house by the firm: Investment due diligence and operations assessments are sometimes performed by external advisors, effectively reducing the current staff size at PE firms.

In past decades, PE firms were comprised almost wholly of general partners who were responsible for making all investment decisions, including portfolio company selection, management, and exit or ''harvest'' strategies. However, as the arena continues to balloon in size, more junior-level employees and other executive staff members now comprise a significant portion of the employment in PE firms. Junior-level employees may include associates and principals, while a firm's executive staff now includes individuals with typical corporate-like titles, such as chief financial officer (CFO), chief executive officer (CEO), chief operating officer (COO), and chief legal officer (CLO), among others.

While members of a firm's executive staff may play a role in the oversight of portfolio companies, these individuals are primarily focused on the success of the PE firm; however, they are sometimes involved in term sheet negotiations (an initial document presented to a prospective portfolio company) and planning the harvest of portfolio companies.

With respect to structure, most PE firms are organized as either limited partnerships (LPs) or limited liability companies (LLCs), instead of as a typical "C" corporation. This type of structure affords the firm a number of significant advantages, including the use of "pass-through" taxation: In other words, the income generated from such an organization is taxed only once, as it flows to the partners. This is in contrast to a "C" corporation, where a corporation must first pay corporate-level taxes on income, in addition to taxes paid by owners as ordinary or dividend income. Moreover, these non-"C" companies are not required to possess boards of directors or hold annual meetings. PE funds are also frequently organized in such a manner as these types of companies may possess a finite lifetime when organized as an LP or LLC.

Private Equity Fund Structure

PE funds are limited-life entities. While a firm may exist for decades, the typical life of a given PE fund is roughly ten years. Throughout this time period, the fund will typically go through four stages: organization/fund-raising, investment, management, and harvest. See Exhibit 1.3 for further information.

During the organization/fund-raising phase, PE funds will recruit investors for their fund, and determine their focus of investment. This is especially true for venture funds, who generally target a specific area of the marketplace for their funding.

Unlike other types of entities, PE funds do not place advertisements in newspapers or journals, issue press releases, or grant interviews to the press in order to promote their funds, largely because they are not permitted to do so (fund regulations are discussed later in this section). Instead, fund promotion is

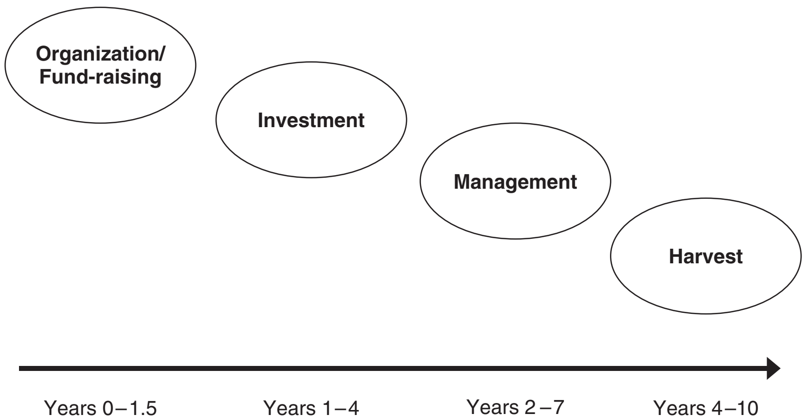

EXHIBIT 1.3 Typical Stages of a Private Equity Fund

largely accomplished through "word-of-mouth" among limited partners—most of whom have a large network of peers. Placement agents may also be used by GPs to promote their fund to qualified investors. In a typical, ten-year, limited-life fund, the organization/fund-raising stage generally occurs over the first year and a half of the fund's life; however, some of PE's largest megafunds currently appear to be raising money at even faster levels.

It is the primary goal of the private equity firm to cultivate long-term relationships with their investors and "gatekeepers," the latter denoting organizations that assist investors in allocating their private equity capital. Gatekeepers are usually compensated with a 1 percent annual fee on committed capital.

These agencies are used by LPs to locate private equity partnerships that match their investment criteria. Investors with little previous experience in private equity investment will often use gatekeepers, as will those with limited resources, as they frequently provide ancillary services such as due diligence for their clients. Many gatekeepers today also act as fund of funds (FoF) managers.

A fund of funds is a partnership that invests capital in multiple private equity funds. Because they cultivate long-term relationships with PE fund managers, a fund of funds manager may be able to assist an investor in the FoF with achieving access to a private equity fund.

With respect to investment structure, in a typical, 10-year, limited-life fund, the organization/fundraising stage generally occurs over the first year and a half of the fund's life; however, some of private equity's largest mega funds currently appear to be raising money at even faster levels.

During the investment stage, GPs will begin scouting deals for their fund. This stage typically encompasses years 1 through 4 of the fund. As discussed in a previous section, the GPs do not collect all of the funds committed by LPs at the fund's inception; rather, they are "drawn down" when the GPs make formal "capital calls," or requests for committed funds. These funds are then immediately invested in portfolio companies.

Beginning in approximately year 2, a PE fund will embark on managing acquired portfolio companies. In some cases, GPs will replace the management team of such a company with professionals from inside the firm, while in other cases, the company's management team may remain in place. Throughout this time period, PE investors may also attract other funds to assist them in raising capital to take the firm to the next level. Such an investment, where multiple firms purchase equity stakes, is called a "club deal."

In years 4 through 10, PE funds seek to realize the gains made on their investments. As time is crucially important in generating high returns—owing to the time value of money—PE funds try to realize their investments as soon as feasibly possible. If these distributions occur long before the fund is liquidated (in year 10), some capital may be reinvested in other portfolio companies, rather than being returned to investors. This activity largely depends on the provisions set forth in the LPA.

Generally, PE funds are named according to a rather lackluster scheme. Suppose that there exists a new PE firm, "Nouveau Equity." Often, the first fund raised by a firm will bear a name similar to "Nouveau Equity," with future follow-on funds being named "Nouveau Equity II," "Nouveau Equity III," and so on. While the naming scheme is somewhat banal, it offers investors an at-a-glance understanding of the age of the firm: generally speaking, PE firms have tended to raise funds every three to four years, so a firm that is starting its fifth fund will likely be about 15 to 20 years old.

Such names are also a source of pride and credibility for management, as it is no easy task for a firm to raise a large number of follow-on funds—the ability to do so speaks highly of the management team in place at a PE firm. If a PE firm manages funds that repeatedly distribute subpar returns, the firm may be disbanded after such a fund is liquidated if they are unable to find investors for a future follow-on fund: With so many funds in the market today, investors have little tolerance for poor returns.

There exists a tremendous push among private equity funds to achieve returns in the top quartile of all investments made by similar funds. One criteria used to evaluate funds is their "vintage year," or year in which they were formed. As is the case with a fine bottle of wine, PE firms with funds in the top quartile of their peers are revered by investors. When these firms seek to raise follow-on funds, they are generally oversubscribed, as investors attempt to gain access to these funds: past truly is prologue in private equity. This is especially true in times where returns in other asset classes are subpar, as the "flight to quality" for many investors compels them to gain access to funds with strong track records.

Unlike other, more liquid investments, PE funds require long-term commitment from investors and managers alike. In order to solidify this relationship in a legal manner, many PE funds are formally organized as limited partnerships that are governed by strict rules set forth in a vital document: the limited partnership agreement. This document outlines the roles and responsibilities of everyone involved in the new organization, with particular focus on two groups of individuals: the GPs and the LPs. (*NB:* The LPA binds *both* the general and limited partners in a legal manner, despite its name.) Several provisions of this document will now be discussed in detail.

Two crucial elements of the LPA are the size of the fund being raised by the GPs, and the LPs' minimum investment size. Despite the ubiquity of Internet stock trading among everyday investors, direct investment in the PE arena is virtually impossible for all but very high-net-worth individuals. (Indirect investments in public PE firms such as Blackstone or Fortress Investment Group are, however, possible for the individual investor.) This is in large part due to the fact that nearly all PE funds have a substantial minimum contribution size that is required of investors in order to participate in the fund: often, this hurdle will be specified in the LPA separately for institutional (i.e., pension funds, banks, etc.) and individual investors. Generally, the GPs will require less of a commitment from individual investors than from institutional investors.

The level of commitment required of investors is kept high in order to minimize the amount of administrative work performed by the firm, and also to ensure that the fund qualifies for exemption from many registration requirements. In this manner, many PE funds organized as limited partnerships or limited liability companies have few investors in order to qualify for an exemption available under Rule 506 of Regulation D of the amended Securities Act of 1933—a primary goal of PE funds.[4]

This regulation specifies that while funds may have an unlimited number of "accredited investors," only 35 "unaccredited investors" are permitted. In brief, "accredited investors" include individuals with historical (and foreseeable) income in excess of $200,000 per year, individuals whose net worth (or joint net worth with a spouse) exceeds $1 million, or families with joint income of over $300,000 per year. Other entities, such as banks, insurance companies, and corporations with assets in excess of $5 million, are also considered "accredited investors." Unaccredited investors are generally refused participation in funds because of disclosure requirements.

Regulation D also imposes very specific restrictions on the solicitations funds may use to raise capital. Specifically, no mass mailings, advertisements, press releases, or informational seminars are permitted. However, funds may engage in solicitation with investors with whom they have preexisting business relationships and with investors who are believed to be "accredited."

Furthermore, fund managers may not provide information to nearly any type of publication (those of both wide and limited circulation) for the purpose of fund-raising; even general articles about a fund and its managers are frequently avoided given that they may be viewed as a promotion of a fund by the SEC. "Tombstone" ads and press interviews discussing the fund are generally permissible *after* the fund has ceased fund-raising. However, given that many PE firms are attempting to raise funds at an increasingly rapid pace, formal interviews with the press are rarely granted, as the GPs do not want to have their actions misconstrued as promoting their next fund.

In order to avoid extensive regulations, PE funds also seek exemption from the Investment Company Act of 1940 in order to avoid registering as investment companies. Exemptions are pursuant to sections 3(c)(1) and 3(c)(7) of the act: The former generally specifies that fund enrollment must be restricted to not more than 100 total investors for domestic funds, or, for international funds, more than 100 U.S.-based investors are not allowed; the latter section permits an unlimited number of investors as long as they are "qualified purchasers." A qualified purchaser is either an individual or entity with greater than $5 million or $25 million, respectively, in investable net worth; "family" companies may be considered qualified purchasers if their investable net worth is over $5 million.

Moreover, GPs commonly maintain exemption from registration as investment advisors by advising fewer than 14 clients. This exemption is permitted under Section 203(b)(3) of the Investment Advisors Act of 1940. With respect to PE funds, the fund itself is treated as a single entity, despite the fact that there are often multiple investors. Hedge funds, however, must now count the number of investors in each of their funds, as opposed to simply the number of funds themselves (this regulation took effect on February 1, 2006). If the number of investors in a hedge fund is over 14, the partners must register as investment advisors. Other regulations, such as the Employee Retirement Income Security Act of 1974 (ERISA), still weigh in heavily on investment in PE funds.

ERISA was enacted primarily to protect the interests of participants in employee benefit plans and their beneficiaries, and it requires plans to supply participants with detailed information: Specific plan features and funding must be disclosed to participants. The act also "provides fiduciary responsibilities for those who manage and control plan assets; requires plans to establish a grievance and appeals process for participants to get benefits from their plans; and gives participants the right to sue for benefits and breaches of fiduciary duty." ERISA has been amended multiple times over its life. These changes, according to the U.S. Department of Labor, were aimed at "expanding the protections available to health benefit plan participants and beneficiaries."[5]

When originally passed in 1974, ERISA instructed pension plan managers that they should invest plan assets "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." This is generally known as ERISA's "Prudent Man Rule." As such terms were initially quite vague, some plan managers believed that the act forbade them to invest in risk capital such as PE: Institutional investments in the PE arena soon plummeted after the act's passage on September 2, 1974. It was not until 1979 that the Department of Labor clarified ERISA's "Prudent Man Rule," explicitly permitting pension fund managers to invest in PE.

Despite the aforementioned clarifications to the "Prudent Man Rule," ERISA still limits the participation of pension plans in PE: Aside from special exemptions, PE funds are not permitted to raise more than 25 percent of the capital for a given fund from pension "benefit plan investors." If the fund qualifies as either a venture capital, real estate investment, or distressed investment operating company, it may be exempt from the above requirements; however, these qualifications are not easy to achieve.

The U.S. Pension Protection Act of 2006 also bore significant influence on PE funds with respect to ERISA regulation, especially the act's revised definition of a "benefit plan investor." Whereas previously the definition included employee benefit plans subject to ERISA, it also included government and foreign country benefit plans; these latter two types of benefit plans are now excluded from the definition. Funds of funds also benefited from this piece of legislation: Only 50 percent of a fund of funds' ERISA contribution to a PE fund is counted as part of the "25 percent rule."

As evidenced by the above-mentioned plethora of regulations (which, still, only represent a fraction of those to which PE funds must adhere), raising a PE fund is no simple task. Because of these regulations, the limited partner agreement set forth when a fund is opened often specifies a minimum and maximum number of investors, along with minimum commitment levels for investors. The targeted fund size is also specified in the agreement as a range, determined by both the general and limited partners.

If the GPs are not able to raise enough capital to meet the lower bound of this range, the fund is not allowed to close, and the limited partners may vote to disband the fund. In contrast, the limited partners also have a vested interest in not allowing the fund size to grow too large: In such a case, the administrative duties of the general partners may become unbearable, and the GP's management team may become stretched too thin managing many investors.

Investors will usually permit the GPs to exceed the prespecified maximum fund size by a small amount (i.e., 5 percent to

15 percent), although all limited partners must agree to such terms. In some instances, limited partners have even permitted the GPs to reopen a formerly closed fund to raise additional capital (e.g., Blackstone Capital Partners V fund). Such a rare step was likely taken because of the limited partners' fears that they would be excluded from future funds should they vote against the fund's reopening.

This instance alludes to an important issue in the current PE arena: that of access to top-tier funds. While the number of PE funds has continued to grow in size, there continually exists a push among limited partners to invest in follow-on funds managed by firms that have demonstrated superior past returns in previous funds: As discussed in a previous section, limited partners usually look to invest their capital in firms that have demonstrated fund returns in the top quartile of all those in a similar investment area. These funds are frequently deemed "institutional-quality" investments.

In addition to possessing strong historical track records, institutional-quality funds are run by GPs who have demonstrated an ability to "get deals done" in the past, and they generally accept contributions only from LPs with whom they've had ongoing relationships. The "star quality" of such funds and their managing firms frequently overshadows other, smaller funds in the PE market.

As such, start-up PE funds, or those with lesser track records have a significantly harder time raising capital than do those funds with historical returns in the top quartile. However, one way in which new and smaller funds can attract first-time investors is by investing a considerable amount of their own capital in the new fund—this contribution will also be specified in the LPA.

Prior to the enactment of the Tax Reform Act of 1986, GPs were required to put up 1 percent of the total capital in a fund (the "1 percent rule"), this requirement has since been removed: There currently exists no such minimum contribution for GPs. Nonetheless, the GPs of well-established funds continue to finance approximately 1 percent of the new fund in order to provide investors tacit assurance that they have significant "skin in the game"; GPs of new funds sometimes contribute more than this amount to demonstrate to investors their confidence in a new fund. Moreover, some LPs require that the general partners contribute more than 1 percent of the fund's capital in order for them to invest in the fund. This is generally true for small-to-mid-market funds.

Types of Private Equity Investment

There are many types of private equity investment; however, this book will focus primarily on venture capital financing and buyout transactions. Exhibit 1.4 presents a taxonomy of private equity investments which will be described in this section.

At one end of the spectrum lies angel investing. Although it has gained more structure in recent years, the market for angel capital remains largely informal, as is often arranged by word-of-mouth: Frequently, lawyers or other business professionals will refer companies to investors through personal recommendations.

Angel investors are generally high net worth individuals who invest in companies with a feasible idea; prototypes of future products may or may not have yet been developed when the investor is first approached. In order to compensate these investors for the large risks they must bear, entrepreneurs provide them with rather large equity stakes, so that they may "ride the upside" of their investment.

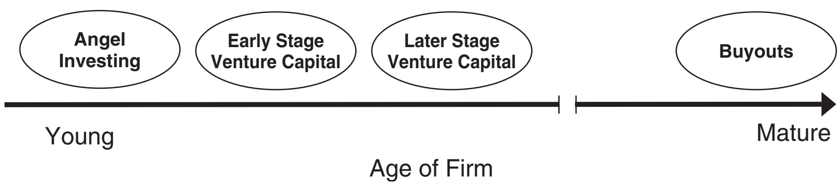

EXHIBIT 1.4 Private Equity Investment Categorized by Age of the Portfolio Company

Despite their interest in the company, the typical angel investor rarely exercises control over the business; the day-to-day operations of the business are left to the entrepreneur, or the management team, although the investor may provide the firm with advice.

Investors in firms of slightly higher maturity than those funded by angels are called "seed investors." These individuals also make equity investments in fledgling firms, but the idea upon which the firm has been formed has a higher probability of success. Seed money may be used recruit management, or increase research and development expenditures so that a product may be refined for sale. Many private equity professionals regard seed funding as the first level of early stage venture capital.

More mature firms seeking early stage venture capital will possess sound business plans and prototypes of commercially-feasible products. These firms will employ their funding to construct manufacturing facilities and establish a supply chain for their product so that it may be sold to retail customers. Such firms may also use their venture capital to build inventory.

The most mature of firms seeking early stage venture capital may already be turning a profit, but they require further injections of cash in order to fund the fast-growing business; opportunities for investment may outstrip the current cash flow of the business. If they possess collateral and, at minimum, a brief history of profits, these firms may also seek debt financing, although interest rates may be unfavorably high.

As is the case with angel investing, providing early stage venture capital is a long-term commitment: Returns on investments may not be realized for many years, and the investments are highly illiquid. These risks are mitigated by the large equity stakes these investors generally receive.

Firms that possess fully-developed products with proven technology may seek later stage venture capital. These firms have a track record of profitability, but may require further cash injection in order to grow the firm beyond what the current level of working capital permits. Also, if early investors wish to cash out of the firm prior to a liquidity event, later stage venture capital can be used to facilitate this need.

It is important to note that all venture capital investments are made in stages. A primary investment is made, and further capital is not committed until the portfolio company is able to meet a "milestone" specified by the terms of investment. This phenomenon of "staged capital" permits investors to limit their downside risk, while allowing entrepreneurs to retain larger equity stakes in their company.

If a portfolio company received all of its funding up front, investors would be squeamish about the entrepreneur squandering the cash and, moreover, the entrepreneur would have to grant his/her investors a large equity stake to receive this funding. By injecting capital in stages, the business is allowed to appreciate in value before further cash infusions are required. As the business's value increases, the entrepreneur can give up a smaller piece of his/her equity in order to receive an infusion of cash.

At the opposite end of the spectrum from venture capital investments lie buyout deals. These transactions focus on the acquisition of mature public or private companies that often have experienced a short-term "blip" in earnings: while historically the company may have produced strong returns for investors, because of market forces or poor management, they may have experienced a recent downturn that the buyout team believes they can remedy.

When searching for potential buyout targets, general partners look for firms with strong, stable cash flows, market leadership, a well-seasoned management team, and a low debt-to-equity ratio relative to industry peers (i.e., a conservative capital structure). Cash is king in leveraged buyout transactions, as cash payments are used to service the debt raised in the deal—not earnings. Moreover, in possessing these qualities, banks will be more likely to lend large amounts of debt to the target firm, as each of these traits increases the probability that the company will make its interest payments in a timely manner. Because of the large amounts of debt used in buyout deals, they are often referred to as leveraged buyouts (LBOs).

While angel and venture capital investments are typically all-equity deals, buyout investments are often funded with large amounts of debt. Control of a company is assumed by buying out the current shareholders with capital derived from a combination of debt (from lenders such as banks) and equity (from PE funds). Due to the high level of debt in buyout transactions, buyout GPs strictly monitor their portfolio companies' cash flow.

In the late 1980s, leverage multiples were especially high as buyout funds pushed the limits on debt financing. As shown in Exhibit 1.5, in 1987, the average leverage multiple for all LBOs was 8.8x earnings before interest, taxes, depreciation,

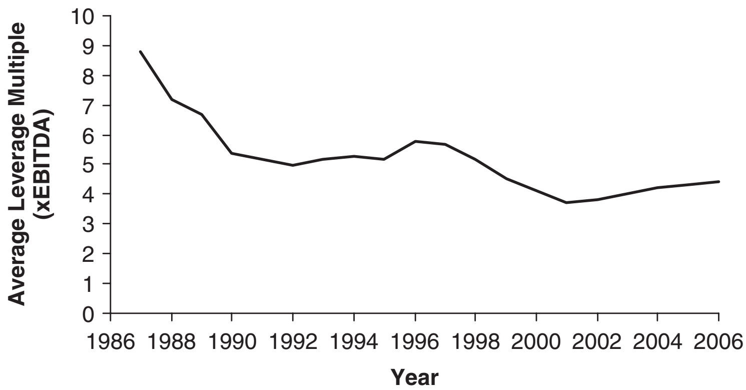

EXHIBIT 1.5 Historical Leverage Multiples for LBO Deals

Sources: Cambridge Associates LLC, Standard & Poor's, Credit Suisse. Leverage multiples are average multiples of highly leveraged loans (L+250 and higher pre-1996, L+225 and higher in 1996–2006; media loans excluded); leverage from 1991 is not included as per Credit Suisse (IRR in 1991 vintage year funds is 27.3%).

and amortization (EBITDA). By 1992, however, this multiple had decreased to 6.0x EBITDA with the Savings and Loan Crisis, and the subsequent recession that resulted from it.

As the economy continued to grow at record pace in the mid-to-late 1990s (real gross domestic product, or GDP, growth averaged 4% per year from 1994 through 1999), banks became more lenient, increasing debt multiples.[6]

However, after the 1990s, debt multiples decreased with the recession of 2001 (a year in which real GDP grew at only 0.75%), although they have rebounded slightly from their recent low of 3.7x EBITDA, set in 2001.

The Private Equity Fund Investment Process

Unlike other types of investment, those in PE do not require immediate funding of pledged capital. To this end, the LPA generally specifies a "drawdown" schedule against commitments that explicitly details the manner in which investors are to pay their committed capital into the fund. This situation is advantageous for both the GPs and the LPs.

While the GPs unquestionably require funds for investment in portfolio companies, the drawdown schedule permits the partners to scout deals in an orderly, nonrushed fashion: If all of the money were collected at the fund's closing date (i.e., the day that the *fund-raising* closes, not the fund itself), the GPs would be under extreme pressure to invest it, rather than simply keep the funds in the company account. Moreover, keeping high balances in the fund's bank account can significantly depress its returns, as only invested money can have the potential to grow. As GPs are continually competing for the top-quartile position based on fund returns, a prespecified drawdown schedule can significantly assist the fund in achieving superior returns.

Nonetheless, the LPA will specify that the investors contribute a given percentage of their committed capital at the fund's closing—usually between 10 percent and 40 percent. Future contribution dates may be denoted in the LPA, or the

GPs may select these dates at their discretion: The latter is likely the case for larger, well-established funds. On these dates, formal "capital calls" are made to the limited partners, requesting their prompt commitment of pledged funds. In any event, most funds draw down 100 percent of their capital by the time the fund is three to four years old.

The LPA may also contain special provisions designed as a check on the GPs' power. In most cases, the LPs can replace the GPs if a majority believe that the GPs are not handling the fund's investments properly. (Sometimes LPAs require a supermajority, or even 100 percent of the limited partners to agree on such an issue in order for it to take place.) In extreme cases, the LPs may vote to dissolve the fund, although such an issue is frequently contested in court by the GPs.

Although unusual, for one reason or another, an LP may default on their commitments to the fund; the penalty associated with such an action is often determined by circumstances surrounding the issue. For instance, if a public pension fund were forced to withdraw from a PE fund due to changes in government regulations, withdrawal penalties would likely be waived. However, should an LP fail to adhere to a capital call, the investor may be liable for interest penalties, and in extreme cases, the LP may have to surrender their stake in the fund.

Penalties may also be less harsh if the GP has a long-standing relationship with a defaulting LP that they would like to maintain. In such a case, the GP may recruit investors or permit the LP to sell its stake in the fund to another investor for fair market value.

Investment Trends

The current trend toward mega-size PE funds is a direct result of the LPs' increasing desire to invest in funds with excellent historical track records, and also the aforementioned changes to the U.S. Pension Protection Act of 2006: Provisions of this act have made it possible for government pension funds to invest large sums of capital in funds, without having to maintain their contribution level below 25 percent of the fund's total assets. This has allowed some states with large pools of assets to contribute significant amounts of capital to top-tier funds.

PE megafunds are also making it continually harder for funds of smaller size to find qualified investors, as the general partners of these smaller funds often do not possess the track record of their larger brethren. In the current PE arena, nearly all LPs want to invest in funds with firms that have historical top-quartile performance. As many GPs will maintain strong business ties with their LPs (recall the example at the beginning of the chapter of CalPERS and Blackstone), this makes it very difficult for new investors to contribute capital to top-quartile funds.

In some cases, GPs who had previously managed successful PE funds with a parent firm will leave the company and start their own fund—or the GP may elect to stay with the PE firm while starting a new fund using their own personal capital. One instance of the latter case is that of Vinod Khosla, a partner at the venture capital–focused Kleiner Perkins Caufield & Byers, starting his own venture firm, Khosla Ventures. Khosla is known within the VC community as a prominent "deal maker" and has been highly recognized by both *Forbes* and *Fortune* magazines.[7]

In some instances, GPs who leave large firms to start their own funds are highly successful, while others are not. When evaluating whether to invest in such a fund, LPs seek to discern if a GP's success was rooted in the *firm's* "secret sauce," or through the tenacity of the individual. Along these lines, the LPs will have intense discussions with the individual managing the new fund and attempt to discern just how much "skin" they had "in the game" on each of the deals listed on their resume.

LPs will grill the prospective fund manager about who specifically "scouted" the deal, who arranged the financing, and in what financing rounds the LP's firm participated. Was the deal actually found by the individual or someone else in the firm? Did another investor participate in the first round, and then bring in this individual's firm for the second round (a safer investment)? Questions such as these, supplemented by numerous phone calls from one LP to another, serve as a principal form of due diligence employed by investors.

Active due diligence pursued by LPs can also help weed out possibly naïve, new fund managers who are purely "chasing returns." With so many hedge funds (nearly 8,000 in 2007 versus under 1,000 in 1997) participating in today's financial arena—most of which are subject to little governmental regulation—there are sometimes managers who will try to lure investors to a "flavor of the month" fund. These managers constantly vacillate in focus: They attempt to raise buyout-focused funds when the buyout market is "hot" (i.e., right now) venture capital funds when venture is "hot" (i.e., circa 1997), real estate funds when they're hot, and so on. It is important that the investor be on the lookout for such managers and funds, and that due diligence is actively pursued before committing any capital to an investment.

Restrictions Placed on the General Partners

While the GPs are the administrators of PE funds, there are often restrictions placed on their activities, to which they are contractually bound. At first blush, one may think that the LPs can largely shape the investment decisions of the GPs, serving in somewhat of a "board of directors" role. However, it is important to note that the LPs are not permitted to direct the day-to-day operations of the fund if they are to retain limited liability status. This detail highlights the extreme importance of the LPA provisions, as the LPs have little say in the fund investment strategy once they turn over their committed capital.

Within the LPA are frequently a series of covenants binding the GPs. Although such covenants have now become commonplace, they were virtually nonexistent until the 1980s as venture returns began to sag (see Exhibit 2.9 for further information). During this time period, some LPs felt that their investing counterparts had strayed from the original focus of the fund and, in the process, had invested money in areas where they lacked expertise; the result was lackluster returns and the genesis of covenants in LPAs. Today, in addition to restrictions on the types of investments GPs may make, convents also specify other numerous restrictions.

Another type of covenant frequently found in a current LPA is one restricting the size of equity investment a GP may make in a potential portfolio company. LPs strongly seek diversification in PE investments due to the risks inherent in such investments. Although the GPs also seek to achieve such diversification, their interests are not completely aligned with those of their counterparts because of the nature of PE distributions.

If the GPs of a fund have invested only a minimal amount of money in the fund (i.e., 1 percent of the fund's assets at closing or less), then they are, in a sense, risk-loving investors: They have little to lose on their initial investment, and a large percentage of carried interest to gain should the investment pay off. In contrast, the LPs are considerably more risk averse than the GPs, given that they stand to lose a substantial amount of capital should the fund not generate adequate returns.

In this way, covenants limiting GPs' contributions to portfolio companies are advantageous for LPs as they limit the GPs' ability to invest in a "walking dead" investment: one that requires a lot of cash but produces little in return. A GP may be motivated to invest significant portions of cash into such a company in the hopes that a capital infusion may set the business on track, while the LP would rather cut his/her losses and invest the capital elsewhere. Such covenants are usually expressed as a percentage of the fund's contributed capital or market value of the funds assets (e.g., not more than 10 percent of the fund's contributed capital may be invested in a single portfolio company).

Furthermore, as many successful PE firms go on to raise follow-on funds, LPAs also contain covenants restricting the practice of having these funds invest in a previous round's portfolio company. For instance, if "Nouveau Equity I" invests in a portfolio company, "Nouveau Equity II" will likely be restricted by its LPA in investing in said company. Without existing covenants, such a practice may be used by GPs in order to salvage a declining portfolio company requiring further capital infusion, or to disguise poor returns in the hopes inflating fund returns: The latter case may especially be seen where a PE firm is seeking to raise a follow-on fund.

Many PE funds—especially those focused on venture capital—frequently record fund assets at values based on prices paid in the last series of financing. As such, a PE firm with multiple funds may try to overinflate a fund's returns by employing the previously described practice: A sister fund may contribute capital to another fund's portfolio company based on a high valuation. This overstated valuation may, in turn, then be used by the PE firm to illustrate to investors the quality of its returns.

As described in previous sections, general partners are under constant, unrelenting pressure to produce returns in the top quartile of all funds. This quest for this lofty position can potentially entice GPs to make unethical decisions without the use of proper covenants.

Covenants may also restrict the GPs' use of debt in financing portfolio companies, requiring total debt levels to remain below a threshold value based on a percentage of the fund's assets. These covenants became popular after some PE funds in the 1980s used above-average levels of debt to finance portfolio companies with the hope that they would have a better chance of growing faster.

A final type of covenant that commonly appears in LPAs is one that relates to the reinvestment of fund profits. Without such covenants, GPs, motivated by yearly management fees, might attempt to increase their wealth by investing intermediate distributions in investments they well know will not pay off by the end of the fund's life. With the LPs' consent, the GPs may then try to extend the fund's life in order to obtain more yearly management fees. Furthermore, as some GP management fees are based on a percentage of the value of assets under management, returning distributions to investors may decrease these fees.

PRIVATE EQUITY FUND-RAISING

The Fund-Raising Process

One of the most important topics in the modern PE arena is that of fund-raising. As many funds raised massive sums of money through the second quarter of 2007—some in the tens of billions of dollars—fund-raising was often at the forefront of many news articles and discussions centered on the arena. Although the current credit markets have put a damper on current fundraising levels, it is nonetheless important to understand why some PE funds experienced such high rates of investment in recent times, and also how the fund-raising process works.[8]

This process is of great importance to all PE funds: It is their *raison d'être* in the financial arena. PE funds are formed in order to raise significant amounts of capital to invest in portfolio companies. Without the necessary funds, investments cannot be made.

There are two principal parties that are at the heart of all PE fund-raising processes: the GPs and the LPs. As discussed in a previous section, the LPs pledge capital commitments to the GPs, who are then responsible for investing these funds in portfolio companies. In some instances, third-party investment advisors (aka "gatekeepers") may also be involved in the fund-raising process.

These advisors, such as Cambridge Associates, Abbott Capital Management, Credit Suisse First Boston (CSFB), and Venture Economics, assist the limited partners in making PE investments. They are extremely knowledgeable about the industry, and generally track the performance of funds and firms, issuing recommendations to LPs about where they should invest their funds.

The GP counterparts to these investment advisors are called "placement agents," or firms that the general partners hire in order to attract capital. Some of the world's largest investment banks, such as Goldman Sachs, have placement agencies. The agents charge a fee for providing this service, with the cost largely being a function of the new fund's size and the GPs' current status as a PE investor. For instance, the fee charged to a smaller, new, non-follow-on fund, with a fledgling management team may be as high as 3.5 percent of the fund's total committed capital; the fee for identical services for a large fund, run by well-established GPs may be as low as 0.5 percent of committed capital.

While the majority of a PE fund's assets are put up by the LPs, the GPs almost always contribute some capital toward the fund. Prior to the Tax Reform Act of 1986, the GPs were required to contribute a minimum of 1 percent of the total funds assets to the fund; this requirement has since been relaxed. Nonetheless, this figure remains the typical contribution level seen in PE funds. There is, however, an instance in which the GPs may contribute more than this customary amount to a fund: the case of a new, first-time fund.

Raising a new fund has never been an easy task; however, the recent popularity of well-established PE firms raising mega-follow-on funds has made such a task even harder. Investors want to see top-quartile returns in previous funds and a seasoned management team with a track record of success, and they want to invest in a fund lead by a PE firm with significant brand equity.

Suppose for a moment that you are about to host a surprise birthday party at your home for a close friend. You've invited about 20 people to attend, along with your friend. While walking around the grocery store, you notice a display for a new brand of beer that deems itself, "The King of Blind Taste Tests." Knowing well that your rather portly friend has a particular penchant for another brand of beer, would you consider buying it for his surprise birthday party? Now, would you consider buying it if the new brand of beer were on sale for 50 percent off? How about if they offered a "no questions asked," money-back guarantee? If the beer advertised that it had hired the brewmaster away from the company making your friend's favorite beer? Probably not. Just imagine the look on your friend's face when he went to pop the top on a can of what he thought was his favorite beverage.

Although somewhat different, the above scenario is rather similar to the case of an LP looking to invest his/her capital in a PE fund: Despite copious enticements, they may still invest in a fund managed by a tried-and-true GP. Nonetheless, in order to encourage LPs to invest in new funds, GPs may put up a larger-than-normal portion of the fund's capital. Such an act serves to demonstrate to potential LPs that the GPs have significant "skin in the game" and, presumably, confidence in their investing abilities. Such an action may also help a fund surpass a threshold size, permitting it to garner more attention (e.g., the $100 million, $500 million, $1 billion, or $10 billion level). Additionally, the GPs of new funds may hire placement agents in order to raise additional capital. There currently exist agents who specialize only in new funds.

In general, the GPs of new funds will likely find a pool of investors to help finance their funds for several reasons, the most important of which is the difficulty LPs experience in attempting to gain access to top-tier funds. PE general and limited partners seek to establish long-standing relationships with one another: Most top-quartile funds already have such relationships with large municipal and corporate pension funds and high-net-worth individuals. As such, when a new follow-on fund is raised by such a firm, the necessary commitments are generally oversubscribed: Not only do those firms with established relationships want in on the new fund, so, too, do a large group of investors attempting to gain access to these funds. Unfortunately, however, many of these investors are not granted access to such funds because of the enormous popularity top-quartile funds generate: Everyone is clamoring for a piece of those pies. For these reasons, some LPs may turn to less well-established funds to invest their money.

GPs of new funds may also find investors by looking for LPs who have motivations beyond those of financial returns. For example, some university endowments may seek to invest a certain portion of their capital in funds that are located within the state; the same might be the case for state pension funds or even corporate pension funds. This is particularly true of limited partners located in California, Colorado, Oklahoma, Indiana, and Ohio. These organizations believe that by setting aside a portion of their capital for such investments, they are contributing to the economic well-being of their home state. Individual investors—as opposed to institutional investors—may also be more receptive to investments in such funds, as many are considerably more risk loving than institutional investors.

Some newer funds may also try to take a very specific industry focus with respect to new investments: This strategy caters to the fact that many LPs are now trying to achieve better portfolio diversification by amalgamating groups of specialized funds. Such a tactic has recently worked well for many mid-market funds.[9]

A final tactic GPs may use in trying to attract new investors is the use of a "lead investor" (aka "special limited partner"). In order to obtain such a title, a lead investor will contribute a large portion of the fund's capital, and may even help subsidize the GPs' marketing costs. In return for such services, the lead investor will often receive a portion of the fund's carried interest, on top of an already substantial portion of the fund's distributions. However, it is important to note that the use of a special LP may scare away some potential investors who recognize that this investor will require a substantial portion of the firm's distributions in return for the risks it must bear.

Determinants of Fund-Raising Levels and Private Equity Investment

Whereas the majority of PE capital once originated from high-net-worth individuals, institutional investors such as public and private pension funds (private equity's largest investors since the early 1980s), insurance companies, banks, funds of funds, and family offices (or private entities that manage investments for high-net-worth individuals) now supply the majority of capital devoted to PE. Among others, several key factors have influenced this change: clarifications to ERISA's "Prudent Man Rule" in 1979, reductions in the capital gains tax rates throughout the 1980s, economic growth, research and development expenditures, and the advent of the LPA.[10]

With the aforementioned elucidations to ERISA's "Prudent Man Rule" in the 1970s came a large influx of capital to the PE arena. While pension funds had invested in the asset class prior to the passage of ERISA, the act temporarily put a damper on investment in PE funds. When the U.S. Department of Labor made clarifications to the "Prudent Man Rule," institutional investors again returned to PE in droves. Funding levels, as shown in Exhibit 1.6, went from a nadir of only $97 million

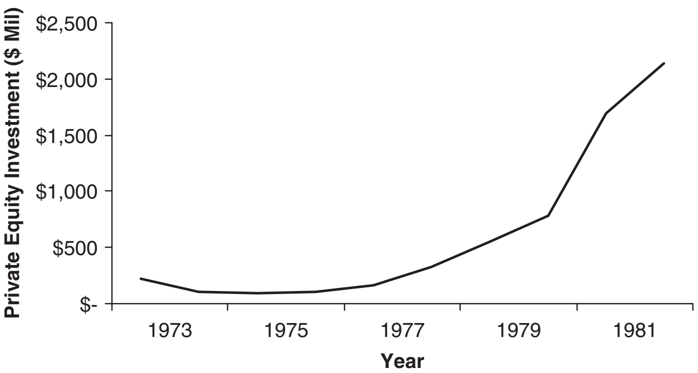

EXHIBIT 1.6 Impact of ERISA on Private Equity Investment Levels

Source: Thomson's *VentureXpert* database.

in 1975, to over $2.1 billion in 1982: In just seven years, investment in PE increased by over 22 times its level in 1975.

Capital gains tax rate reductions also contributed significantly to the popularity of PE as an investment class. From the late 1960s through the 1970s, the federal capital gains tax rate increased dramatically. Having long been constant at 25 percent since the early 1940s, the maximum tax rate on capital gains began to rise in 1968, to 26.9 percent. While a seemingly insignificant increase, a broadly levied surtax of 10 percent was also imposed on all taxable individuals beginning in this year to finance the Vietnam War (in effect, increasing the capital gains—and all other—tax rates). The capital gains rate continued to rise through 1977, when it hit a historical high of 39.9 percent. However, with the end of the 1970s, came a dramatic shift in these tax rates: Beginning in 1979, the maximum capital gains tax rate was slashed to 28 percent with the passage of the Stieger Act, then to 23.7 percent in 1981, and again cut to 20 percent in 1982 (where it remained until 1987).[11] Exhibit 1.7 summarizes maximum federal capital gains tax rates since 1970.

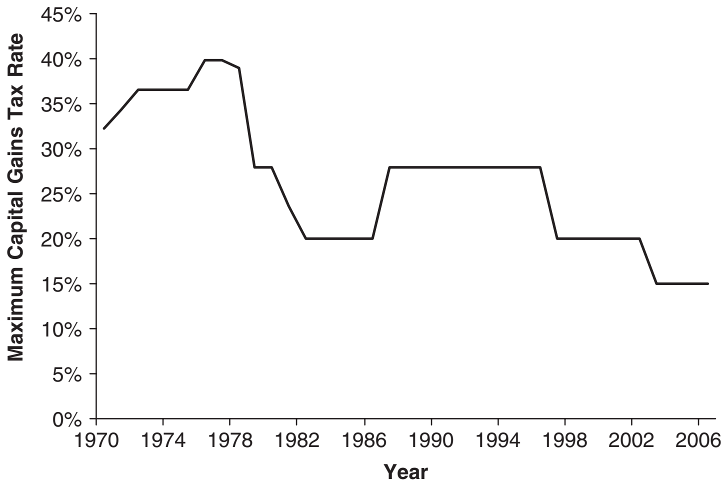

EXHIBIT 1.7 Historical Maximum Federal Capital Gains Tax Rates

Although some may argue that capital gains rate taxes have little influence on capital inflows to PE—largely because many investors incur no tax liabilities on gains—others assert that capital gains rate taxes bear heavily on the decision of would-be entrepreneurs to leave their current employers to start new businesses. This is due to the fact that entrepreneurs primarily benefit from the appreciation of their equity stake in new venture companies.[12] As such, when capital gains tax rates decrease, those individuals with an ‘‘entrepreneurial spirit’’ are further enticed to start a new company: They will be able to retain a greater amount of the return on their investment when taxed at a lower rate.

Nonetheless, irrespective of the *perceived* influence of tax rates on PE fund-raising, recent analysis has shown that PE investment levels and capital gains taxes rates are inversely related: The correlation between these from 1970 through 2006 is −0.61.[13]

Debt also plays a pivotal role in many buyout transactions, especially buyouts where portfolio companies are often highly leveraged. For this reason, market interest rates highly influence private equity investment activity. Using the federal funds rate (FFR) as a proxy for a PE firm’s cost of debt, analysis has shown that there is a significant inverse relationship between PE investment levels and the FFR. More specifically, the correlation coefficient for both values from 1970 through 2006 is −0.44 (again, the *p*-value is quite high, at less than 0.01). Historical FFRs are presented in Exhibit 1.8.

Note the sizeable ‘‘valley’’ in the FFR from approximately 1985 through 1988. This availability of relatively cheap debt (compared with the astronomically high interest rate levels of the late 1970s and early 1980s) helped fueled the previous private equity boom period.[14]

Finally, general economic growth, as measured by real GDP is also highly related to PE investments, as economic growth creates new opportunities for venture capital entrepreneurs, and also the ability for firms under buyout management to

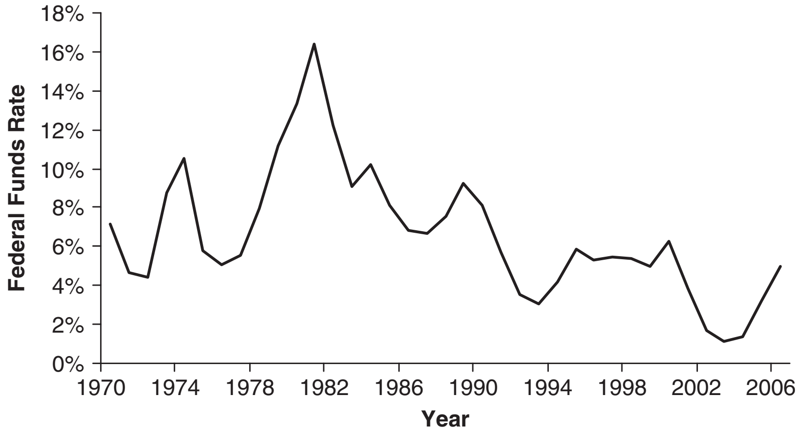

EXHIBIT 1.8 Historical Federal Funds Rates since 1970

grow. Analysis has shown that the correlation between PE investments and real GDP is 0.81, indicating a strong, direct relationship (the p-value of this correlation is less than 0.001).[15]

With so many factors driving investment in the PE arena, which are the most significant when attempting to determine the key drivers behind investment levels? In a similar manner to Gompers and Lerner (1998) and Brophy and Wadecki (2007),[16] answer this question by using a multifactor regression model to analyze PE investment levels. Overall, the authors find that real GDP is the most significant driver of PE investment levels in the United States, with this quantity explaining approximately 65 percent of the variation in PE investment levels (as measured by *R-squared*). Capital gains tax rates and interest rates are also highly significant drivers of PE. In short, governmental policies can have significant influence on the PE arena.

NOTES

1. *Source:* Thomson's *VentureXpert* database.
2. *Id.*
3. *Source:* www.blackstone.com/company/index.html.

4. For further information, *see* http://sec.gov/about/forms/regd.pdf.
5. For further information, *see* www.dol.gov/dol/topic/health-plans/erisa.htm.
6. For further information, *see* http://www.ers.usda.gov/Data/Macroeconomics/Data/HistoricalRealGDPValues.xls
7. For further information, *see* www.khoslaventures.com.
8. For further information, *see* P. Gompers, J. Lerner, M.M. Blair, and T. Hellman, "What Drives Venture Capital Fundraising?," Brookings Papers on Economic Activity. Microeconomics, 1998; or D. Brophy and A. Wadecki, "Understanding Private Equity Investment," 2007, mimeo.
9. For further information, *see* L. Kreutzer, "Some Mid-Market Firms Thrive, but Others Are Dying on the Vine." *Private Equity Analyst*, March 2007.
10. For further information, *see* Gompers and Lerner (1998).
11. For further information, *see* www.taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=161.
12. For further information, *see* J. Poterba, "Venture Capital and Capital Gains Taxation." NBER Working Paper No. 2832, 1989.
13. For further information, *see* Brophy and Wadecki (2007), mimeo.
14. *Id*.
15. *Id*.
16. See note 7.