

SECTION I

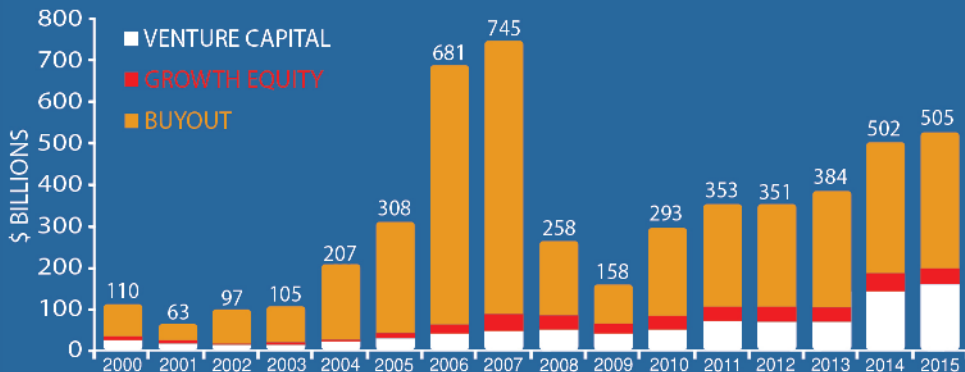
Private Equity Overview

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The first section of the book provides readers with a high-level introduction to the institutional private equity (PE) market—from early-stage venture capital to growth equity and buyouts, plus a brief description of several alternative PE strategies. While buyouts have historically accounted for the vast majority of global PE capital deployed,¹ venture capital and growth equity investment activity has steadily increased as the industry matured over the past decades (see Exhibit A).

Section I is by far the least technical part of this book, intended to familiarize newcomers with the asset class and the concept of investing institutional capital in private companies in return for equity stakes. While crucial for readers new to PE, professionals familiar with the industry may choose to move directly to later sections of the book.

Exhibit A: Total PE Industry Capital Deployed by Strategy



Source: Preqin

1. Buyouts have accounted for more than three-quarters of industry capital deployed between 1980 and 2015. Source: Preqin.

Section Overview

Chapter 1. Private Equity Essentials: This chapter defines the traditional limited partnership fund model, specifically the players involved, a fund's investment lifecycle, and typical fund economics and fee structures. To be clear, our work refers to the organized PE market, i.e., professionally-managed equity investments by specialized intermediaries (PE firms) and their institutional backers; it excludes other forms of "informal" private capital investments.

Chapter 2. Venture Capital: Venture capital (VC) generally flows into early-stage companies—start-ups—that offer high risk/high return investment opportunities. We introduce the different types of venture investors (business angels, start-up incubators and accelerators, VC funds, and corporate VCs) and explain the use of VC at different points in a company's development, from proof-of-concept to commercialization and scaling up. Both aspiring entrepreneurs as well as future venture investors will find this chapter useful.

Chapter 3. Growth Equity: Acquiring minority equity stakes in fast-growing companies is the focus of growth equity funds. Managing multiple stakeholders without a control position is a key challenge for these funds; establishing a productive working relationship with existing managers and owners is therefore a key determinant of success. This chapter is particularly relevant for readers interested in PE in emerging markets.

Chapter 4. Buyouts: Buyout funds acquire controlling equity stakes in mature and sometimes listed target companies, often employing ample amounts of debt in leveraged buyouts (LBOs). The skillset required to execute large LBOs and drive value post-investment differs from that needed for growth equity or VC: it requires both financial and process management skills, combined with the ability to create operational value in the portfolio firms.

Chapter 5. Alternative Strategies: In the final chapter of this section, we explore alternative PE strategies focused on investing in distressed businesses and real assets. The former requires unique skills to restructure and improve a company's operations (turnaround) or its balance sheet (distressed debt), while the latter describes a range of strategies (investing in real estate, infrastructure, and natural resources) that use a PE operating model and adapt it to distinct industry verticals.

PRIVATE EQUITY ESSENTIALS

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At some point in their development, all companies will need either a helping hand or a shot in the arm. A fresh injection of capital or external managerial expertise is often necessary to help organizations overcome developmental challenges, realize their full potential and seize the opportunities that lie ahead. Start-ups hunt for the visionary capital that will enable them to turn a concept into a launched product. Mature companies are increasingly subject to market disruption, increased competition or pressure to update manufacturing processes and corporate governance structures. Companies that have been performing poorly for a prolonged period of time need to identify and then rectify the problems that confront them. Family businesses must honestly address succession planning (“it is only but three generations from shirtsleeves to shirtsleeves”²).

The needs and demands of businesses at such critical inflection points often exceed the capabilities and services provided by the established financial institutions and consulting firms. Capital markets, for instance, are unlikely to offer a solution for small and medium-sized enterprises (SMEs). Into this void steps private equity (PE) in the form of venture, growth, and buyout funds, at its best offering patient and long-term capital, dedicated expert advice and hands-on operational support.

In the last four decades PE has emerged as the transformation agent of choice for companies seeking change; at times, it is the only choice for a business in need of capital and a risk-sharing partner to facilitate future growth. The PE ecosystem has grown dramatically during that time; as of 2015 the industry (including its alternative strategies and co-investments) has over US\$4.5 trillion in assets under management, of which US\$2.3 trillion are deployed through core PE strategies. This capital is being invested and managed by over 8,000 professional funds globally. Understanding this industry—its drivers and its dynamics—is a must for entrepreneurs, owners of family businesses, board members of multinationals and senior managers.

So what exactly is PE? PE funds invest long-term capital in private (or, at times, public) companies in return for an equity stake that is not freely tradable on a public market.³ Our definition of PE includes so-called “take-privates” (i.e., delistings of public companies) and private investment in public equity that come with specific governance rights. This book focuses strictly on the activity of professionally managed PE funds advised by highly specialized intermediaries (PE firms) and excludes “informal” private capital, such as investments made by business angels or families who typically draw on their own private wealth.

This first chapter gives our readers a high-level overview of PE funds, by defining their structure and the motivation of the key players involved. We then explain how PE funds go about their business, both from the general partner’s (GP’s) and limited partner’s (LP’s) perspective and shed light on the often complex economics and fee structures in PE.

2. Origin unknown but the quote is often attributed to Andrew Carnegie.

3. In our context, PE takes on a broad definition that includes VC, growth capital, and buyout funds. It should be mentioned that other sources might restrict the definition of PE to buyout activities and consider VC to be a separate asset class. Further, PE is frequently defined as investments in private companies but buyout activities extend to investments in and the privatization of public companies. For the sake of clarity, our definition of “private” equity refers to the status of the equity stake held by the PE fund post-investment.

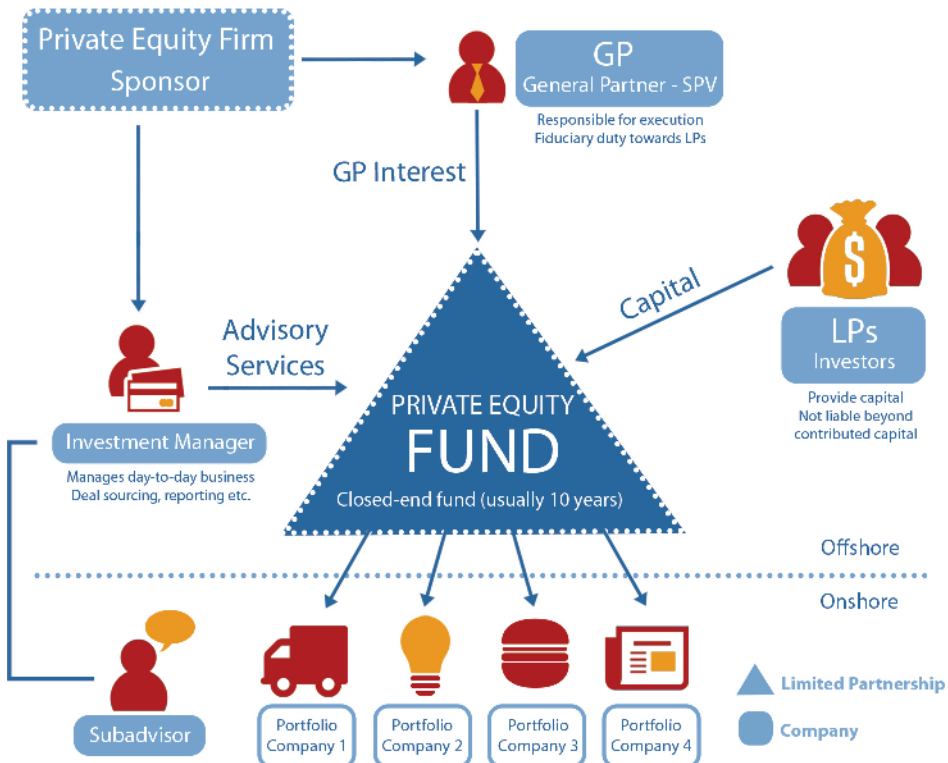
PRIVATE EQUITY FUNDS DEFINED

A PE fund is a stand-alone investment vehicle managed by a PE firm on behalf of a group of investors. The capital is raised with a clear mandate to acquire equity stakes in private companies and divest them over time.

Most PE funds globally are set up as closed-end limited partnerships and operate as “blind pool” vehicles. Closed-end funds have a finite lifespan and require investors to commit capital for the fund’s entire term—typically 10 years—without early redemption (or withdrawal) rights.⁴ While investors in a PE fund have a clear idea of its broad mandate (for example, mid-market European buyouts), they have no say in the choice of the individual companies that a fund will invest in, hence the term “blind pool.” Certain jurisdictions use limited liability companies or corporate structures as the vehicle of choice for a PE fund, but they are the exception.

We will start with a closer look at the parties involved in a limited partnership PE fund structure, as shown in Exhibit 1.1.

Exhibit 1.1 Limited Partnership PE Fund Structure



4. The PE secondaries market can provide liquidity for an LP wishing to sell its interest in a PE fund. This market has developed rapidly over the last decade with dedicated funds raised for the express purpose of acquiring secondary fund stakes. See Chapter 24 Private Equity Secondaries for more information.

PE FIRM: A PE firm is a company with expertise in executing a venture, growth or buyout investment strategy. It raises and advises a fund—and, if successful, over time a family of funds—generally through two separate yet affiliated legal entities: the GP and the investment manager. Members of a PE firm typically hold all the key directorships and other decision-making positions of both the GP and the investment manager for every fund raised by the firm. Establishing these separate legal entities insulates the PE firm from liabilities related to and its principals from any claims on the PE fund. Examples of notable PE firms are buyout firms Kohlberg Kravis Roberts (KKR) and APAX Partners as well as venture firms Sequoia Capital and Kleiner Perkins Caufield Byers.

LIMITED PARTNERS: Investors or LPs contribute by far the largest share of capital to any PE fund raised. LPs participate merely as passive investors, with an individual LP's liability limited to the capital committed to the fund. Investors active in PE include private and public pension funds, endowments, insurance companies, banks, corporations, family offices, and fund of funds.⁵ LPs are purely financial investors and cannot be involved in the day-to-day operation or management of the fund or its investee companies without running the risk of forfeiting their limited liability rights. LPs legally commit to provide capital for investment when it is drawn down (or "called") by the PE fund and they receive distributions of capital—including a share of profits—upon successful exit of the fund's investments.

GENERAL PARTNER: A fund's GP is wholly responsible for all aspects related to managing the fund and has a fiduciary duty to act solely in the interest of the fund's investors. It will issue capital calls to LPs and make all investment and divestment decisions for the fund in line with the mandate set out in its Limited Partnership Agreement (LPA). The GP may delegate some of the management functions to the investment manager or a PE firm's investment committee (IC),⁶ but remains fully and personally liable for all debts and liabilities of the fund and is contractually obligated to invest the fund's capital in line with its mandate.⁷ A GP—and in turn a PE firm's partners and senior professionals—will also commit capital to the fund to align its interest with that of the fund's LPs by ensuring that the firm's partners have "skin in the game"; the GP stake typically ranges from 1 to 5% and rarely exceeds 10% of a fund's total capital raised.

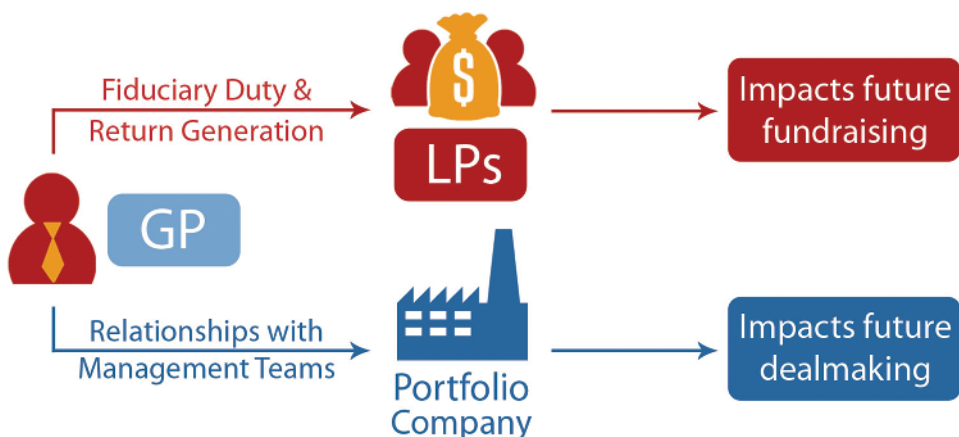
INVESTMENT MANAGER: In practice, the investment manager⁸ conducts the day-to-day activities of a PE fund; it evaluates potential investment opportunities, provides advisory services to the fund's portfolio companies, and manages the fund's audit and reporting processes. The manager is paid a management fee by the fund for providing these services, some of which may be passed on to a subadvisor. The management fee is typically set at around 1.5–2% of committed capital during the investment period of the fund; after the end of the investment period, it is calculated

5. A fund of PE funds (fund of funds) is a vehicle that invests in a portfolio of individual investment funds. A fund of funds offers clients diversified exposure to the PE asset class without the need for deep investment expertise or lengthy due diligence on the individual funds. An additional layer of fees applies.

6. The IC is typically a committee of the GP and makes the binding investment and divestment decisions for the fund under delegated authority from the GP ("binding" in the sense that once the IC votes, there is no other vote needed or taken).

7. GPs are usually set up as distinct special purpose vehicles (SPVs) for each fund; these SPVs serve as the GP for only one fund to avoid cross-liabilities between related funds of the PE firm. Please refer to Chapter 16 for further details on fund formation.

8. Investment managers will also be referred to as advisors or simply managers.

Exhibit 1.2 Key Relationships GPs Must Manage

on invested capital and may step down to a lower rate. More information on fee structures can be found later in this chapter.

PORTFOLIO COMPANY: Over its lifecycle, a PE fund will invest in a limited number of companies, 10–15 on average, which represent its investment portfolio. These companies are also referred to as investee companies or (during the due diligence process) as target companies. A PE firm’s ability to sell its stakes in these companies at a profit after a three- to seven-year holding period will determine the success or failure of the fund.

From the perspective of the PE firm and its affiliated entities, the business of PE comes down to two simple yet distinct relationships: on the one hand, the firm’s fiduciary duty towards its LPs and on the other hand its engagement with entrepreneurs, business owners and management teams in its portfolio companies (Exhibit 1.2). Establishing a reputation of professional conduct and value-add will ensure access to both future fundraising and investment opportunities.

THE GP PERSPECTIVE

LIFECYCLE OF A PE FUND

A traditional PE firm’s business model relies on success in both raising funds and meeting its target return by effectively deploying and harvesting fund capital. PE funds structured as limited partnerships are typically raised for a 10-year term plus two one-year extensions, commonly referred to as the “10+2” model. Generally speaking, a GP will deploy capital during the first four to five years of a fund’s life and harvest capital during the remaining years. The two optional years allow the GP to extend a fund’s lifespan at its discretion if and when additional time is needed to prudently exit all investments.

Exhibit 1.3 shows the overlapping timelines for the fundraising, investment, holding, and divestment periods of a closed-end fund.

Exhibit 1.3 Lifecycle of a PE Fund

FUNDRAISING: PE firms raise capital for a fund by securing capital commitments from investors (LPs) through a series of fund closings.⁹ A PE firm will establish a target fund size from the outset—at times defining a “hard cap” to limit the total amount raised in case of excess investor demand. Once an initial threshold of capital commitments has been reached, the fund’s GP will hold a first closing, at which time an initial group of LPs will subscribe to the fund and the GP can start to deploy capital. A fund holding its first closing in 2016 is referred to as a “vintage 2016 fund,” a fund with a first closing in 2017 will be known as a “vintage 2017 fund,” and so on. Fundraising will typically continue for a defined period—12 to 18 months—from the date of the first closing until the fund reaches its target fund size and a “final closing” is held. The total amount raised by a PE firm is known as a fund’s committed capital.

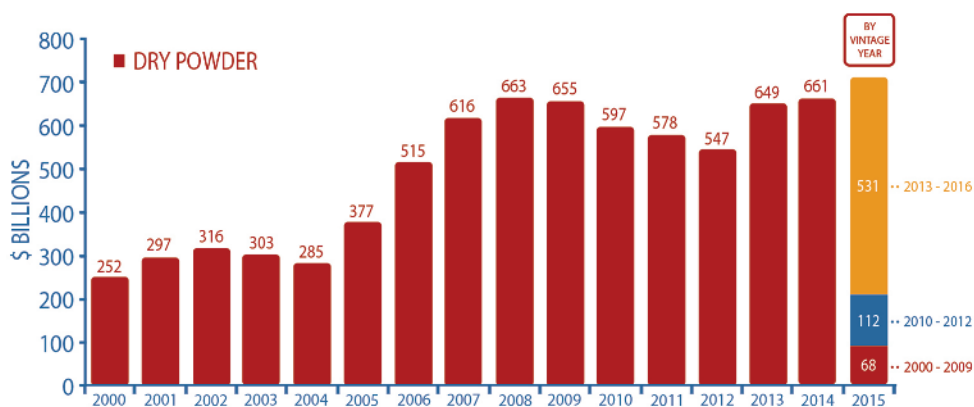
INVESTMENT PERIOD: Rather than receiving the committed capital on day one, a GP draws down LP commitments over the course of a fund’s investment period. The length of the investment period is defined in a fund’s governing documents and typically lasts four to five years from the date of its first closing; a GP may at times extend the investment period by a year or two, with approval from its LPs. Once the investment period expires, the fund can no longer invest in new companies; however, follow-on investments in existing portfolio companies or add-on acquisitions are permitted throughout the holding period. A fund’s LPA may also permit its GP to finance new investments from a portion of fund realizations within a certain limited period after divestment (this is known as the recycling of capital), thus increasing a fund’s total investable capital.

GPs draw down investor capital by making “capital calls” to fund suitable investment opportunities or to pay fund fees and expenses. LPs must meet capital calls within a short period, typically 10 business days. If an LP fails to meet a capital call, various remedies are available to the GP. These include the right to charge high interest rates on late payments, the right to force a sale of the defaulting LP’s interest on the secondaries¹⁰ market and the right to continue to charge losses and expenses to the

9. Please refer to Chapter 17 for more details on the fundraising process and its dynamics.

10. Please refer to Chapter 24 Private Equity Secondaries for further details on the mechanics behind the transfer of such LP stakes.

Exhibit 1.4 PE Industry Dry Powder



Source: Preqin

defaulting LP while cutting off their interest in future fund profits. The portion of LPs' committed capital that has been called and invested is referred to as contributed capital. A fund's uninvested committed capital is referred to as its "dry powder"; by extension, the total amount of uninvested committed capital across the industry is referred to as the industry's "dry powder." Exhibit 1.4 shows the increase of the industry's dry powder since 2000; the 2015 data adds perspective on its origin by grouping dry powder according to vintage year.¹¹

HOLDING PERIOD: Holding periods for individual portfolio companies typically range from three to seven years following investment, but may be significantly shorter in the case of successful companies or longer in the case of under-performing firms. During this time, a fund's GP works closely with portfolio companies' management teams to create value and prepare the company for exit.¹²

DIVESTMENT PERIOD: A key measure of success in PE is a GP's ability to exit its investments profitably and within a fund's term; as a result, exit strategies form an important part of the investment rationale from the start.¹³ Following a full or partial exit, invested capital and profits are distributed to a fund's LPs and its GP. With the exception of a few well-defined reinvestment provisions,¹⁴ proceeds from exits are not available for reinvestment. When a fund remains invested in a company at the end of a fund's life, the GP has the option to extend the fund's term by one or two years to avoid a forced liquidation.¹⁵

11. Dry powder in Exhibit 1.4 is for venture, growth and buyout investment strategies. Source: Preqin.

12. Please refer to Chapter 13 Operational Value Creation for more background.

13. Please refer to Chapter 15 for a detailed description of exit considerations and the related processes.

14. The capital invested in a deal and returned without any profits achieved, may be reinvested under the following conditions: (a) a so-called "quick flip" where an exit was achieved within 13–18 months of investing during the investment period; or (b) to match the amount of capital drawn down to pay fees, with the target to put 100% of the fund's committed capital to work. These rules are defined in a "remaining dry powder" test.

15. Please refer to Chapter 20 Winding Down a Fund for additional information on end-of-fund life options.

Box 1.1

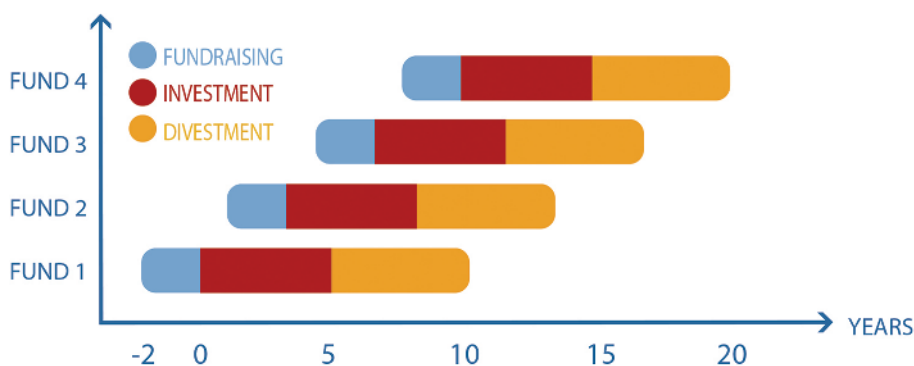
RAISING A SUCCESSOR FUND

Established PE firms will raise successor funds every three to four years and ask existing LPs to “re-up”—or reinvest—in their new vehicle. PE firms will typically begin raising a successor fund as soon as permitted by the LPA, usually once 75% of the current fund’s capital is invested or has been reserved for fees and future deals.

PE firms see their business as a going concern, meaning they continuously work on a deal pipeline of potential investee companies, make investments and divestments. To efficiently capitalize on opportunities in the market, it is crucial for PE firms to have access to capital, ready to be drawn down and deployed, at all times. This also allows a firm to maintain stable operations, employ an investment team and maximize the efficiency of its resources.

Exhibit 1.5 shows the lifecycle of a successful PE firm with a family of four funds.

Exhibit 1.5 Lifecycle of a Successful PE Firm



THE LP PERSPECTIVE

COMMITTING CAPITAL AND EARNING RETURNS

Investors have traditionally allocated capital to PE due to its historical outperformance of more traditional asset classes such as public equity and fixed income.¹⁶ However, this outperformance comes with higher (or rather different) risks first and foremost due to the illiquid nature of PE investments. Given its lack of liquidity and the long investment horizon of a PE fund, hitting a target allocation to PE is a far more challenging task than maintaining a stable allocation to any of the liquid asset classes.¹⁷ In addition, PE funds’ multiyear lock-up and 10-day notice period for capital calls introduce complex liquidity management questions.

16. Please refer to Chapter 19 Performance Reporting for a detailed comparison of PE and public market performance.

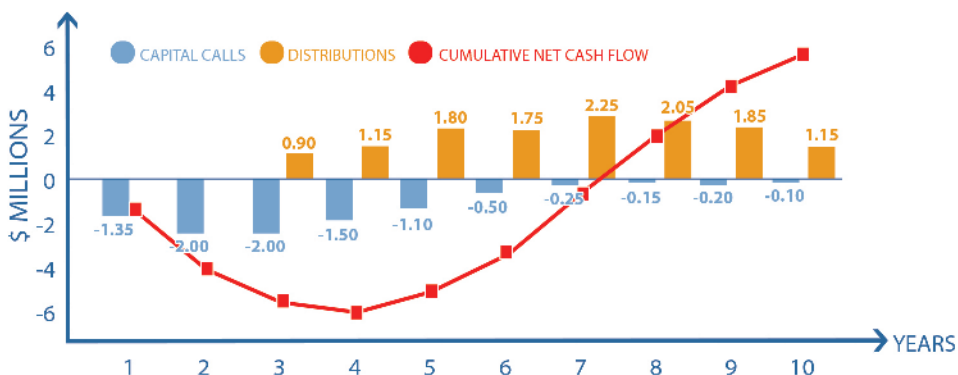
17. Our Chapter 18 LP Portfolio Management takes a closer look at the challenges of deploying assets under management into PE and VC; Chapter 23 Risk Management complements the discussion.

Effectively managing portfolio cash flows is among the key challenges faced by investors in the PE asset class. LPs starting a PE investment program from scratch must prepare for years of negative cumulative cash flows before a positive net return will eventually be generated by their PE portfolios. Seasoned investors with a well-diversified exposure to PE, on the other hand, will often have commitments to well over 100 funds and a complex set of cash flows to manage. A PE fund's "J-curve" provides a way to visualize the expected cash flow characteristics of an LP's stake in an individual PE fund and the challenges related to managing a PE portfolio.

THE J-CURVE

A PE J-curve represents an LP's cumulative net cash flow position—the total capital invested along with fees paid to the PE firm minus the capital returned to the LP by the GP—in a single fund over time. Exhibit 1.6 illustrates the characteristic cash flow for an LP (with a US\$10 million commitment to a \$100 million fund) over the fund's 10-year life. For simplicity's sake we assume both consistent drawdowns from the GP and exits split evenly across the years. It should be noted that capital calls and distributions are difficult to forecast with any degree of accuracy, requiring LPs to develop a flexible approach to cash management.¹⁸

Exhibit 1.6 PE Fund Cash Flow J-curve



Early in the investment period, the J-curve has a steep negative slope, as a fund's initial investments and management fees (paid on committed capital) result in large cash outflows for its LPs. As the fund begins to exit its portfolio company holdings, distributions of capital slow the J-curve's descent; some funds may in fact show a positive slope before the end of the investment period. While the low point of a J-curve is theoretically defined as the fund's total committed capital, J-curves rarely dip below 80% of committed capital due to the time required to deploy capital and early divestment activity. In fact, many funds do not even reach a net drawdown of more than 50%.

Following the start of the divestment period, the J-curve turns upward as exit activity picks up and invested capital plus a share of profits are returned to LPs. Capital called for follow-on investments and management fees continue to generate small LP outflows during the divestment period. As soon as the J-curve crosses the x-axis, the fund has reached breakeven; the final point on the J-curve represents an LP's total net profit generated by the fund.

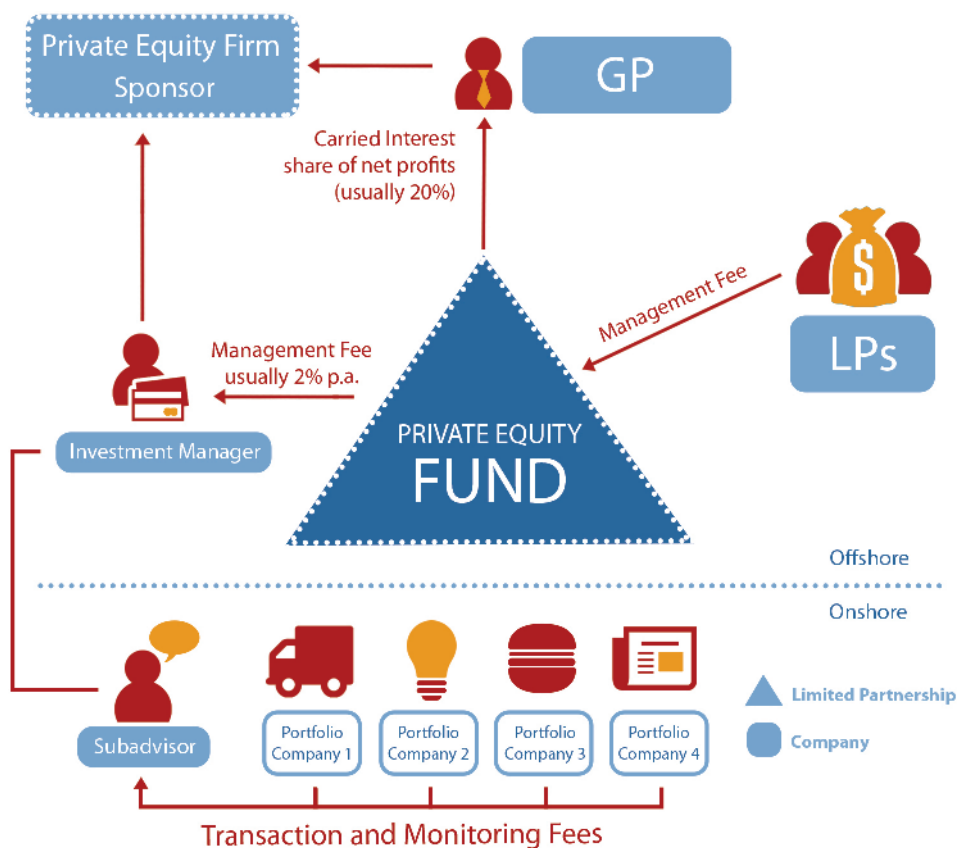
18. Please refer to Chapter 18 for further insight into the cash management challenges LPs face when starting a PE investment program or when managing multiple funds in a PE portfolio.

While LPs will attempt to optimize their portfolio allocation, modeling cash flows as well as net asset values remains challenging, given the blind pool nature of the funds and the overall scarcity of data in PE. The secondaries market nowadays offers a realistic avenue to add liquidity, shorten the J-curve and manage a PE portfolio proactively.

THE FEE STRUCTURE AND ECONOMICS OF PE OR WHO EARNS WHAT?

The typical fee structure of a PE fund is designed to align the economic interest of the PE firm and its fund investors. The fee structure in PE is commonly referred to as “2 and 20” and defines how a fund’s investment manager and GP—and in turn its PE professionals—are compensated: the “2%” refers to the management fee paid by the LPs per annum to a fund’s investment manager while the “20” represents the percentage of net fund profits—referred to as carried interest or “carry”—paid to its GP. The clear majority of profits, 80%, generated by a fund is distributed pro rata to a fund’s LPs. As long as carried interest remains the main economic incentive for PE professionals, their focus will continue to be on maximizing returns, which in turn benefits the LPs. Exhibit 1.7 visualizes the flow of fees and share of net profits to the entities involved in a PE fund.

Exhibit 1.7 PE Fees and Carried Interest



Returns in PE are typically measured in both internal rate of return and multiples of money invested.¹⁹ Given a fund's cost structure, its net return—that is, the return on capital generated by the fund net of management fees and carried interest—is the relevant metric for its investors and LPs will ultimately define success on that basis at the end of the fund's life.

We take a detailed look at fees and carried interest below.

MANAGEMENT FEES: A PE fund's investment manager charges the fund—and ultimately its LPs—an annual management fee to cover all day-to-day expenses of the fund, including salaries, office rent and costs related to deal sourcing and monitoring portfolio investments. In the early days of PE, the management fee charged was an almost consistent 2% per annum, yet currently it ranges from 1.3 to 2.5% depending on the size and strategy of a fund and the bargaining power of the PE firm during fundraising. For example, it is accepted that smaller, first-time funds will charge higher fees to cover their fixed costs, while large funds and mezzanine funds often charge lower fees. Since the global financial crisis of 2008 management fees have come under pressure, sometimes in an indirect way, through a sizable increase in free or discounted co-investment opportunities for LPs.²⁰

Management fees accrue from a fund's first closing onwards and are usually paid either quarterly or semi-annually in advance. Management fees are charged on committed capital during the investment period, and on net invested capital after the investment period; the rate charged on invested capital may step down from the initial percentage.²¹ This fee structure causes fee revenue to drop over the lifetime of a PE fund as capital is deployed and exits occur. Early in a fund's life, management fees are typically drawn directly from investors' committed capital, while proceeds from profitable exits may be used to offset management fees later in a fund's life.

OTHER FEES: An investment manager may charge additional fees to the fund, particularly in the context of a control buyout. The main fee categories are transaction fees linked to a fund's investment in and exit from a portfolio company and monitoring fees for advisory and consulting services provided to portfolio companies during the holding period. Other fees also include but are not limited to broken deal fees, directors' fees, and other fees for services rendered at the fund or portfolio company level. Over the last decade, management fee offsets have increasingly been included in LPAs; when these offsets are in place, management fees charged to the LPs are reduced by a percentage of "other" fees collected by the fund—historically between 50 and 100%, now trending towards 100%. These offsets reduce the fee burden for LPs and shift a portion of the fee-based compensation from the GP to the limited partnership as a whole.

CARRIED INTEREST: Proceeds from successful exits are distributed to a fund's LPs and its GP in line with a distribution "waterfall" set out in a fund's LPA.²² Carried interest is the share of a fund's net profits paid to its GP—typically 20%—and serves as the main incentive for a PE firm's principals. In a typical distribution waterfall, PE funds will return all invested capital and provide a minimum return to investors—a fund's hurdle rate²³ or

19. See Chapter 19 Performance Reporting for additional detail on fund performance measurement.

20. See Chapter 21 for further details on this co-investment trend.

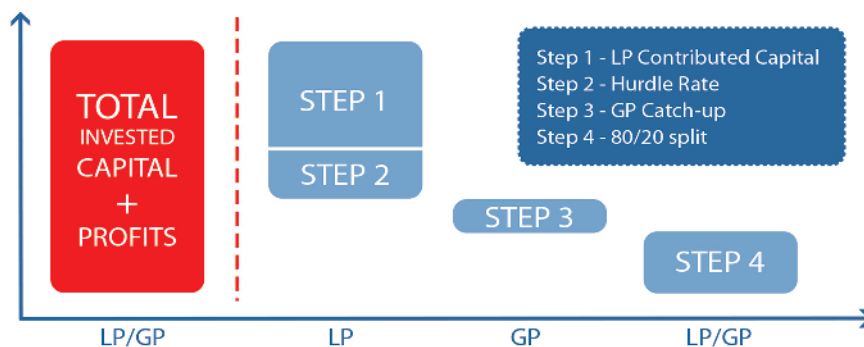
21. Net invested capital consists of contributed capital minus capital returned from exits and any write downs of investment value.

22. Please refer to Chapter 16 Fund Formation for a detailed description of distribution waterfalls and examples of carried interest calculations.

23. The hurdle rate, typically set at 8%, will be negotiated during fundraising. A fund is only "in the carry" (i.e., performance incentives for the GP kick in) once it has reached an annual return of 8%.

preferred return—before any carried interest is paid out to the GP. After the hurdle rate has been reached, PE funds will typically include a “catch-up” mechanism that provides distributions to the GP until it has received 20% of all net profits paid out to this point. Thereafter, all remaining profits are split at the agreed-upon carried interest percentage (80–20). Should a GP for any reason receive more than its fair share of profits, a clawback provision included in a fund’s LPA requires GPs to return excess distributions to the fund’s LPs. Exhibit 1.8 shows the basic steps common to all distribution waterfalls.

Exhibit 1.8 PE Fund Distribution Waterfall



The industry uses two standard models to calculate distributions to LPs:

- *All capital first*: Also known as a *European-style waterfall*, this structure entitles a GP to carried interest only after all capital contributed by investors over a fund’s life has been returned and any capital required to satisfy a hurdle rate or preferred return has been distributed.
- *Deal-by-deal carry (with loss carry-forward)*: Also known as an *American-style waterfall*, this structure entitles a GP to carried interest after each profitable exit from a portfolio investment during the fund’s life, but only after investors have received their invested capital from the deal in question, a preferred return and a “make whole” payment for any losses incurred on prior deals.

A detailed description of distribution waterfalls together with examples of carried interest calculations can be found in Chapter 16. Fund Formation.

A Look Back at the Last 45 Years

By T. Bondurant French, Executive Chairman, Adams Street Partners

In reflecting on the changes in the private equity industry over the last 45 years, fundraising trends were one of the first things that stood out. Looking at fundraising data for the private equity industry, I was a little taken aback to see that 1960 through 1983 were barely visible on my bar graph, compared to the funds being raised today. In 1972, \$225 million was raised for venture funds in the US; buyout funds didn’t exist and Kleiner Perkins was a first time fund. Venture fundraising bottomed in 1975 at \$60 million.

By 1979, the economy was better, capital gains tax rates had been lowered from 50% to 28%, venture-backed companies were bounding (Intel, Microsoft, Apple, and Genentech), and \$800 million was raised for venture funds. In the early 1980s, venture funding really took off on the back of excellent returns and a rising stock market. In 1983, \$3.7 billion was raised and for the first time the term “mega fund” was used.

It is hard to imagine today, but we had no real data to evaluate the managers with and there were very few realized deals. Almost everyone was a first time fund and there were virtually no formal standards in place. Benchmarks, quartile rankings, written valuation guidelines, and placement agents did not exist. Neither did industry conferences and newsletters, with the exceptions of the National Venture Capital Association’s annual meeting and the Venture Capital Journal. The fax machine hadn’t yet been invented, but a new venture-backed company, Federal Express, helped us with overnight documents.

Back then, fundraising was exceptionally difficult. Most pension consultants did not follow or cover the asset class. We spent a lot of time doing educational presentations for trustees and their consultants at offsite retreats, board meetings and pension conferences. During the 1980s, our hard work finally began to pay off. As we had actual data going back to 1972, we became pension funds’ source of information on expected returns, standard deviations and correlation coefficients for the private equity “asset class.” The new term “asset class” implied a transition from a niche activity to something that was becoming institutional. We took the lead in establishing the first industry performance benchmarks, chaired the committee that established the private equity valuation guidelines, and worked with the CFA Institute to establish the guidelines for private equity performance reporting.

Throughout the 1970s and for most of the 1980s, we had lived in a US and venture-centric world. Now, the buyout business was emerging as a new practice within the world of private equity. Pioneered by KKR, CD&R and a handful of other firms, the use of leverage to buy and manage a company was a new idea. The development of the high yield bond market, led by Michael Milken of Drexel Burnham Lambert, made this practically possible on a much wider scale than previously thought. Heretofore, “junk bonds” were formerly high grade bonds of companies that got into trouble and were in or likely to be in default. The idea of a new issue “junk bond” was a new concept.

In 1980 only \$180 million was raised for buyout funds in the US. This grew to \$2.7 billion in three years, and \$13.9 billion by 1987. As with many things in the financial and investment markets, this was a good idea carried to an extreme, culminating in the takeover of RJR Nabisco in 1989 by KKR (as told in a book and a movie, both called *Barbarians at the Gate*).

During the second half of the 1980s, managers in Europe and Asia began to adopt “American style” venture capital and buyout practices. Many of these managers made fundraising trips to the US as, relatively speaking, there were more willing investors there. Along with pension funds and endowments, nearly all of the private equity funds of funds were based in the US.

By 1990, the US was in a recession and a savings and loan crisis. Buyout fundraising dropped dramatically, with only \$6 billion raised in 1991. Fortunately, lessons were learned by all parties and the buyout business grew steadily and more rationally throughout the 1990s. What were originally highly leveraged transactions morphed over time to become today's private equity industry, which provides a variety of equity capital, including growth capital, to a broad range of industries and businesses.

By the mid-1990s, the globalization of the private equity market was on the horizon. A number of venture and private equity managers were becoming established in emerging markets. By the mid-2000s, institutional investors were interested in global exposures enhancing their diversification and return potential by accessing rapidly growing economies. Significant money was raised by Asian general partners, particularly in China. Fast forward to today, the private equity industry has expanded to nearly every corner of the globe.

While many things about the private equity industry have changed over the last 45 years, several things remain the same. Private equity remains a people business and, at Adams Street, we understand that the people we invest with are of paramount importance. Spending time with them is an important part of developing real relationships based on trust and mutual respect. Nothing has changed in that regard and these relationships are a critical part of our investment process. The characteristics of successful private equity firms are the same today as they were decades ago. It takes mutual respect, independent thinking, and an optimal mix of experience and energy. At the heart of all enduring firms are good investors who have time to work with their companies, an international awareness and network, and a differentiated deal flow edge.

I am very proud of what the private equity industry does. We generate above average returns for our investors while also providing capital to finance business growth. This financing cuts across a wide spectrum of company stages, industries, and geographies. The end result is greater growth in job creation, wealth, and GDP than would otherwise be possible.

CLOSING

PE as an asset class continues to grow and evolve, both in developed and emerging markets. Business operators the world over—from entrepreneurs looking for start-up funding, to SME business owners with global ambitions, to management teams interested in buying out a corporate division—often find the right partner in PE funds to invest in their ambitions. As a result, PE is deeply entrenched in the economic model and will remain an important driver of business transformation globally.

KEY LEARNING POINTS

- PE is a simple business—buy a stake in a company (minority or majority), improve the business and sell it after a (limited) holding period.
- The preferred method employed by PE firms is to raise and invest individual funds, which they manage on behalf of investors (LPs). PE funds are typically structured as closed-end limited partnerships that require investors to commit capital for a period of 10 years or more.
- PE funds differ from traditional asset classes due to their illiquidity and the unpredictable cash flows generated from their investments.
- Both the fee structure and profit sharing arrangements in PE ensure alignment of interest; incentives change as the funds mature.

RELEVANT CASE STUDIES

from *Private Equity in Action—Case Studies from Developed and Emerging Markets*

Case #1: Beroni Group: Managing GP–LP Relationships

Case #3: Pro-invest Group: How to Launch a Private Equity Real Estate Fund

Case #6: Adara Venture Partners: Building a Venture Capital Firm

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