Embracing a Consistent Approach to Private Equity Investing

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Private equity offers investors a unique set of risk-and-return characteristics that can enhance long-term wealth accumulation and portfolio diversification. But this asset class also can add complexities to an investment program that investors should understand.

Private equity investing is defined as taking an equity stake in a privately held company. Because no ready market exists for these investments, they are regarded as relatively illiquid, long-term investments that can offer return advantages over more-traditional investments.

For private equity investors, probably the most important factor governing long-term success is whether they apply a consistent, recurring approach to investing. This disciplined method is more likely to provide well-diversified exposure over time as well as sustain targeted allocations to private equity as a percentage of total portfolio value. It also is more apt to result in a self-funding private equity program that ultimately generates excess cash distributions and produces better overall risk-adjusted performance.

Benefits of Private Equity

Historically, these investments have produced higher returns than those of publicly traded securities. Private equity fund managers provide their portfolio company investments with a combination of management expertise and investment capital. These managers as a whole have shown the ability to create value through operational changes and financial engineering, with the results reflected in their funds’ returns.

Private equity, in general, also has lower correlation to publicly traded equities and many other asset classes, which may help enhance a portfolio’s diversification.

Cash Flow Timing

Investors should expect a different level of involvement with these investments compared to most other asset classes. With some exceptions, most private equity investments are finite vehicles with a decade-plus average lifespan that generally progresses in the following stages:

- Commitment by investors
- Capital calls from investors
- Acquisitions of portfolio companies
- Dispositions of portfolio companies
- Returns of capital and any profits to investors

The resulting timing of cash flows differs markedly from many other types of investments and means a commitment—whether to an individual fund or fund of funds—can be complex to implement and monitor.

For instance, although the investor commits up-front a specific amount of capital to a fund manager, he or she does not provide that money to the fund at the outset. Instead, the investor will receive capital calls to fulfill a commitment only when capital actually is needed for acquisitions. This may take several years as the fund manager identifies, researches, and acquires a portfolio of companies. Then, as a fund’s portfolio of companies matures, the manager will sell companies and return capital plus any profits to investors until all companies in the portfolio are sold.

Private equity is a self-liquidating asset class based on its fundamental structure. This suggests that investors, if they are to maintain their desired target weighting to the asset class, face important ongoing decisions about when and how to reinvest to maintain their allocation. For an investor who commits to only one private equity fund, the life of that investment ensures that exposure will return to zero in the future.

Consistency Is Key

Thus, investors who want to maintain consistent exposure to the asset class will need to commit to multiple funds. This raises two important questions: “How much?” and “How often?” Investors who commit too little, or too infrequently (or both) will fall short of their targets, as illustrated by the following examples and figures.

Assume, for illustrative purposes, that a portfolio has a 7-percent private equity target allocation. Our analysis suggests an investor commit 100 percent of the target allocation to a first fund (7 percent multiplied by the then-current total portfolio market value) and 80 percent of the target to subsequent funds every other year (80 percent multiplied by 7 percent, or 5.6 percent of market value in the future).

Our analysis demonstrates how a commitment every other year can be optimal. Figure 1 shows the outcome for an investor who seeks to maintain a 7-percent portfolio allocation but who committed capital only every fourth year. Over time, this investor would see a significant shortfall in exposure based on our hypothetical assumptions.

Figure 2 illustrates that an investor who committed capital every two years would have reached and maintained the target exposure over time.

Based on the hypothetical assumptions of our models, an every-other-year approach to funding commitments...
can put an investor on a path to reaching and maintaining the desired private equity exposure.

Remember that private equity investing entails significant risks, and our models and assumptions may not reflect actual investor experience. In certain cases an investor may need to increase or reduce his or her pace of commitments based on fund performance and market conditions. Investors who implement a consistent investment approach also may fall short of or exceed their target allocations.

Cash Flow Vantage Points
To provide more context, below are examinations of private equity cash flows from two perspectives: first, that of the investor, then from that of the fund or fund of funds.

The Investor’s Perspective
In figure 2, the first commitment would equal 100 percent of the target allocation, and subsequent commitments would equal 80 percent of the target allocation. For example, if an investor with a $10-million portfolio has a 7-percent private equity target allocation, the
Private Equity Fees

To run their operations and compensate them for their efforts, private equity managers typically charge a management fee and also take a share of any profits. The share of profits also is known as carried interest (see definitions that follow). Funds-of-funds managers charge a management fee for their services as well, and some funds-of-funds managers also receive a carried interest. Investors interested in private equity should take note of these costs of gaining exposure to the asset class.

These fees result in a reduction in an investor’s return on their investment. Management fees usually are charged on a quarterly basis, and reduce an investor’s account value over time. Carried interest does not occur on a set timetable. It is charged when managers experience portfolio company liquidity events, and typically is assessed after an investor has been paid back previously charged management fees. Most private equity managers that charge carried interest design their funds so they will not share in profits until their investors receive back their invested capital and management fees allocated to a portfolio company.

Investors ultimately will receive a return net of fees, and only need to concern themselves with meeting capital calls and receiving distributions. Investors do not have to worry about paying separate invoices for management fees and carried interest. Fund managers are responsible for making all the necessary calculations for each investor’s capital account on a regular basis, and undergo annual audits to confirm their methods.

Carried interest

The manager’s share of the profits generated by a private equity fund. The carried interest, rather than the management fee, is designed as the fund manager’s chief incentive to generate strong performance. A 20-percent carried interest—meaning that the remaining 80 percent of profits go to limited partners—has been the industry norm, although some historically strong performing firms now take a 25-percent or even 30-percent share of fund profits. Fund-of-funds managers may charge up to 10 percent of profits for their services on top of the carried interest of underlying funds.

Management fee

This annual fee, typically a percentage of limited partners’ commitments to a fund (as opposed to market value), is meant to cover the basic costs of managing and administering a fund. Management fees usually are in the range of 1.5-percent to 2.5-percent per annum, and often scale down in the later years of a fund to reflect the reduced work load of the general partner. The management fee is not intended to be the primary source of incentive compensation for the investment team. A fund’s main incentive compensation is its carried interest. Fund-of-funds managers assess an average management fee of 1 percent, which is charged on top of the management fees of underlying funds.

The Fund’s Perspective

Figure 4 illustrates how cash flows from one fund can affect future funds when an investor chooses a consistent investment program. In the first row of “buckets,” fund A initially is a shell, represented by the empty bucket. As the fund identifies and makes acquisitions, commitments are called, and cash is placed into the fund, which then invests in a diverse array of companies.

Over time, the fund’s management seeks to enhance equity value by influencing the operations and finances of the companies in which the fund has invested, represented by the full bucket. As these companies appreciate and reach their potential values, they are sold, often through initial public offerings (IPOs) or strategic sales. These sales result in returns of capital...
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plus any profits to investors. Should an investor in fund A decide not to reinvest these harvested proceeds into additional private equity holdings, the investor’s interest in fund A eventually would be liquidated, eliminating private equity exposure.

In a consistent investment program, however, the investor wants to reach and maintain a certain target exposure. After committing to fund A, the investor makes a subsequent commitment to fund B, which also starts as a shell. As fund B identifies and makes acquisitions, commitments are called and cash flows into fund B.

At this point, the investor has a seasoned holding in fund A and a less-mature investment in fund B. As fund A harvests companies, distributions may be used to finance investments in fund B. Over time, both funds move into full-harvest mode, and the investor makes a commitment to fund C. Cash that flows into fund C consists of proceeds from the sale of fund A and fund B portfolio companies.

In this example, the program has become self-funding, as distributions from earlier funds exceed annual capital call requirements from later funds.

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The J-Curve Effect

One benefit of a consistent investment program is the elimination of the J-curve effect as commitments to new funds are made. During the first five years after creation of a private equity fund, there typically will be periodic capital calls, potentially no distributions, and thus negative cash flow for investors. In later years, as the companies in the portfolio become seasoned and dispositions begin, individual fund cash flows should turn positive. This is shown in figure 5.

Once investors cease adding cash to a program and simply reinvest distributions from earlier funds, the negative J-curve cash flow associated with the launch of new funds is expected to be eliminated and overall cash flow is positive, as illustrated in figure 6.

Other Factors to Consider

The unique nature of this type of investing means an investor’s level of involvement will be greater than with many other types of investments. Several important factors will require specific attention.

Multiple Commitments

At any one time, an investor may have commitments that exceed, in aggregate, the desired allocation. Investors need to become comfortable with this, as older...
commitments are retired over time and replaced by new commitments. Even though the actual market value of a private equity program may not exceed an investor’s desired allocation, the amount of outstanding and unfunded commitments will.

Illiquidity
Commitments to private equity funds are primarily illiquid, with liquidity coming only from intermittent distributions mainly related to proceeds from portfolio company dispositions. Redemptions of interests are not allowed, and transfers of interests are restricted.

Fee Transparency
Nearly all private equity funds charge fees based on commitment level rather than market value. One advantage is that management fees are known from the outset, since commitment levels do not change once they are made.

Investing Committed, Uncalled Cash
Investors must decide where to put assets that have not yet been called to finance commitments. Typically, annual cash requirements will range from 10 percent to 20 percent of the commitment amount over the first six years of each commitment. Thus, investors need liquid assets available to meet anticipated capital calls each year.

Some investors choose to invest in stable money market funds. Others are
willing to take additional risk and invest in equities to try to increase returns before capital is called. Those interim investment choices should reflect the investor’s risk tolerance and preferences.

**Redeploying Cash Distributions**

Investors must decide how to handle distributions. As discussed, investors might use some distributed cash to fund current capital calls. If distributions exceed call requirements, the investor might choose to fund investments in other asset classes or satisfy liquidity needs.

The allocation of excess cash—whether at the front or back end of a fund’s life—should be considered, as it may affect the investor’s overall allocation to private equity. At a minimum, investors should review annually their private equity allocation and, based on our models, conduct a comprehensive review at least every two years when they need to decide about additional commitments.

**Considering the Benefits**

Allocating a portion of assets to this asset class provides diversification and the potential for enhanced returns versus other asset classes. Adopting a consistent, systematic investment approach to private equity investing may help achieve a desired allocation while providing the additional benefit of creating a self-funding program. It is also likely to generate excess cash distributions and produce better overall risk-adjusted performance for investors.

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**Endnotes**

1 All projections are based on assumptions. These assumptions are based on a model that, on average, a private equity investment will earn an overall 15-percent net internal rate of return and a 1.75x multiple on invested capital. Total investor portfolio is also assumed to grow 7 percent annually in nominal terms. Actual results may vary significantly from projections. Past results are not necessarily indicative of future performance. Information provided for illustrative purposes and not intended as an indication of any strategy employed by Northern Trust. Information should not be considered investment advice or a recommendation of any strategy or security described herein as it does not take into account an investor’s own circumstances.

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