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THE FUNDAMENTALS: Limits are put to the test

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The global private equity industry that invests billions of dollars each month is regarded by some as a wonder of 21st century capitalism.

It has enjoyed phenomenal growth in recent years and is now populated by thousands of firms that specialise by segment - ranging from venture and growth capital to mid-market and large buy-outs as well as by geography and industry sector.

The private equity model at its core boils down to two activities - raising capital and investing it in companies.

In theory, the big attraction to investors is that private equity outperforms other asset classes. Private equity also has a role providing "change capital", whether in restructuring, re-energising or refocusing an existing business, or fostering innovation via ventures or start-ups.

The starting point for most firms is for an individual or group of individuals to set up a limited liability partnership (LLP) and raise capital from a group of investors. The LLP has a limited life, often 10 years, and is a closed-end fund.

A plan is pitched to investors via in-house investor relations teams or by external placement agents.

This document will set out the fund's investment strategy, and describe in detail how the private equity manager defines the fund's focus and why it expects to invest profitably. It will set out the track record of the private equity manager and cover a range of terms and conditions.

Individual private equity funds vary in size, ranging from a few million dollars for venture capital funds to the more than $10bn raised by industry titans such as Blackstone, Carlyle, Kohlberg Kravis Roberts and Texas Pacific Group. New upper limits continue to be tested as the industry matures.

The private equity managers that run LLPs are known as the general partners (GPs), while investors are known as limited partners (LPs). LPs include US state pension schemes, historically the most important source of capital in the industry, institutional investors including banks and insurance companies, university endowments and high net-worth individuals.

To date, private equity has not been easily accessed by retail investors, although in the UK there are some quoted private equity groups, notably 3i, while Blackstone plans to list in the US this year.

KKR and Apollo Management last year launched publicly-traded investment vehicles on the Euronext exchange in Amsterdam. Fund-raising is a time-consuming process that GPs undertake every few years, a cycle that does not necessarily match the investment cycle.

The fund comes into being at the time of its "first close".

This happens after a specified minimum amount of capital has been secured. The first close is an important milestone as it means expressions of interest from LPs are converted into firm commitments allowing funds to be drawn down and invested at the discretion of the GP.

A number of subsequent "closes" can then be held until the final close, when the fund's capital-raising programme ends.

The first part of the fund's life is the investment phase, which starts from the date of the first close and normally lasts for up to five years - although it can be shorter depending on how quickly the capital is deployed.

Both GPs and LPs do not want too much exposure to an individual deal, so are unlikely to devote more than 10 per cent of the fund's total committed capital to any one transaction. Diversification is important because private equity is a high risk, high reward endeavour.

In the case of buy-out firms, the GP will use capital drawn down from the fund together with a debt finance package to fund individual deals.

Deals may be financed with one part of equity from the fund with three or four parts of debt.

There may also be opportunities for LPs to invest additional capital in certain deals via direct "co-invest" arrangements.

Buy-out firms normally look to take a controlling equity position in their investee companies, with stakes also held by the executives who run these businesses on their behalf.

Once under its ownership, the company could be restructured or expanded with bolt-on acquisitions.

However, there are often variations, particularly in venture capital.

For example venture capital deals are often 100 per cent equity financed because it is difficult or impossible to raise debt finance for companies with little financial track record.

It is also more common for venture capital groups to back their portfolio companies for longer periods than three to five years.

Private equity firms only buy companies to sell or harvest them three to five years or more after initial investment. The aim is to make a profit on the equity.

Capital is recouped from investee companies by selling them to corporate buyers or to another private equity firm and from initial public offerings.

The private equity firm might also see a return of capital via a refinancing - whereby an investee company takes on a new and often heavier debt burden with some of the proceeds from the fresh debt package used to pay the backers a dividend.

GPs generate income and profits from two sources - they charge fees on the capital they manage and they hope to generate carried interest - a form of profit once performance hurdles are met.

Carried interest that flows to the GPs is normally based on the performance of the entire fund rather than on individual deals.

As a rule of thumb, once the fund has returned to investors the capital drawn from them, plus management and other fees, the subsequent profits are split.

The ratio is 80 per cent to LPs and 20 per cent to the GPs.

The GPs also charge management fees that range from 1 to 2.5 per cent. Management fees are more lucrative to the GPs in years one to five when the fund is being invested.

However, they persist in the second half of a fund's life on a stepped down basis at something like half or three-quarters of the headline first five years rate.

The GPs also charge a variety of fees for portfolio company monitoring, transaction and advisory fees.

Some funds have deal-by-deal carried interest, while others generate profits for the GPs once all funds drawn from the LPs have been repaid and a hurdle rate is passed.

The hurdle rate returns to the LPs the cost of various fees that the GPs has previously charged. The GPs should be chiefly motivated by rewards generated from carried interest.