Executive Summary

Private equity is a relatively young asset class, but has evolved substantially over the last two decades. Due to the long-term horizon required for investing, private equity is dominated by institutional investors, such as pension plans, foundations, endowments and family offices.

Investors are increasingly turning to alternative asset classes, such as private equity, to enhance the modest returns expected from traditional equity and fixed income asset classes.

While private equity has historically delivered attractive returns in excess of the broad public markets, the difference between top quartile and median returns is substantial. As a result, selecting managers who can deliver top quartile results is imperative to develop a successful portfolio.

Investors should approach private equity as they do other asset classes: develop a plan, use discipline in executing the plan and vigilantly monitor investments. However, certain unique characteristics of the asset class require a specialized approach in portfolio construction and investment selection.

We believe that as the private equity industry continues to evolve, opportunities for attractive returns will remain available to opportunistic and selective investors.
Introduction
Private equity is a type of alternative investment that involves investing in privately held companies. For most investors, private equity investing is accomplished through illiquid, long-term partnerships, also referred to as funds that are formed by private equity firms. Funds are generally closed-end with 10-15 year lives, which require investing with a long-term horizon.

There are various types of private equity investments, such as venture capital, leveraged buyout (LBO) and mezzanine investments, each with varying risk/return profiles. For example, a venture investment may involve a company formed by an entrepreneur to develop a new technology. Buyouts generally involve more mature companies with operating history, revenue and cash flow.

Investors allocate capital to the private equity class generally for return enhancement. Most investors target a base return equal to a broad public equity index plus a premium of 3-5% over a long term horizon.

Evolution of the Asset Class
Private equity is a relatively young asset class. While its roots can be traced back over 50 years, it was not until the late 1970s, when regulatory and tax law changes allowed U.S. pension funds to enter the asset class, that private equity became accepted as an institutional asset class. In the 1990s, private equity truly came into vogue and gained broader acceptance among institutional investors. During the decade of the 90s, there was a tremendous boom in the private equity industry, with the emergence of brand name firms managing multi billion dollar sized funds. Over this period, the pool of U.S. private equity funds has grown from $5 billion in 1980 to over $203 billion in 2005, outpacing the growth of almost every other financial asset class.

While the expansion of private equity has been striking, the potential for future development is even more impressive. Despite its growth, the overall private equity pool today remains relatively small. For every one dollar of private equity in the portfolio of U.S. institutional investors, there are about $40 of publicly traded equities. Both the demand for and supply of private capital are expected to continue to expand. In terms of demand, privately held firms continue to require capital to finance growth, manage succession or refocus corporate strategy. The supply of private equity is also likely to continue growing. In recent years, many institutional investors have invested in private equity for the first time. Many investors have also decided to increase their allocations to private equity.
How Big Is the Private Equity Market?
The private equity market has experienced robust growth over the last 15 years, during which nearly $1.7 trillion was committed to private equity partnerships.

![Private Equity Capital Commitments by Year ($ billions)](chart1.png)

Source: Thomson Financial Venture Economics.

Who Invests in Private Equity?
Given the illiquid nature of private equity investments, investors in private equity should have long-term horizons. Institutional investors, such as foundations, endowments and pension funds, represent the vast majority of investors in private equity. Additionally, high net worth individuals and family offices invest in the asset class.

![Private Equity Capital Commitments by Investor Type 1995-2005](chart2.png)

Source: Thomson Financial Venture Economics.
Why Invest in Private Equity?
Private equity essentially acts as a turbo-charged form of equity exposure. As a component of a diversified investment portfolio, private equity’s primary role is to provide return enhancement. Over the long term, private equity has, on average, generated an approximate 5% premium over the broad public markets.

The public equity and fixed income markets are often described as “efficient,” meaning outperforming the market over the long term is a difficult prospect. Conversely, private equity, like other non-traditional asset classes, is an inefficient market. Not all private equity managers have equal access to good investment opportunities, management resources, research and industry expertise. As a result, the best private equity managers can leverage advantages to generate above-market returns.
returns, as evidenced by the substantial difference between top quartile and median returns for private equity. Conversely, the spread between top quartile and median returns for public equity and fixed income are much narrower, indicative of more efficient markets.

**What Does all This Mean?**
Above all other factors impacting a private equity portfolio, the quality of the managers selected by an investor is the key determinant of success in the asset class. History shows that the best private equity managers deliver returns substantially above average performing managers as well as the public equity markets. If you’re investing in private equity, differentiating and accessing the best managers is the key to success.

**Risk in Private Equity**
Accompanying the potential for high returns is higher risk. Defining risk in private equity, though, is a subjective process compared to risk measurement in the public markets. In terms of sensitivity to fundamental economic risk factors, private companies and publicly traded companies are quite similar. However, in the private equity market, assets are infrequently valued. When statistical analysis is used to measure the risk profile and diversification benefits of private equity investments, the results are misleading. In our view, private equity investments are highly correlated with public equity and are more risky due to the introduction of unique risk factors, such as the illiquidity of private equity investments, leverage or the early stage nature of certain private companies (venture capital).
One of the greatest risks in private equity is selecting managers that fail to deliver top performance, which can substantially dilute portfolio performance. Before entering the asset class, investors would be wise to understand the competitive dynamics of the market, who the best managers are and their ability to access these managers.

**Considerations for Investing in Private Equity**
Investors should approach private equity in a similar manner as other asset classes: develop prudent investment plans, rely on experienced professionals to evaluate investment opportunities and utilize a systematic approach to monitoring investments. However, because of certain complexities inherent to the asset class, private equity requires specialized planning and portfolio management techniques, which require a blend of investment, legal and accounting expertise.

Some of these key considerations for investors in private equity are discussed below.

**Structure**
Due to their illiquid nature, private equity investments are long-term oriented and typically governed by contracts between the investor and the manager. There are several methods investors can use to access private equity investments.

- **Direct investment** – transaction involving the purchase of debt or equity securities of a private company.
- **Direct Fund** – a pool of capital formed to make direct investments.
- **Fund of Funds (FOF)** – a pool of capital formed to make investments in funds.

### Private Equity Fund Lifecycle

**Fundraising (6-18 months)**
The first phase of a fund’s lifecycle is the fundraising period, during which a fund is marketed to potential investors who commit capital. Capital commitments from investors are essentially promises to fund future investments as a fund manager identifies them.

**Investment period (5-6 years)**
Once fundraising is complete, the fund closes and begins its investment period, which typically lasts five years. During the investment period, the fund manager calls capital from commitments provided by investors to make investments.

**Realization period (5-8 years)**
After the investment period, the fund enters the realization period, which lasts five to eight years on average. During the realization period, investments are sold or liquidated, and proceeds are returned to investors.
Most investors gain exposure to private equity through direct funds or FOF. Direct funds and FOF are typically structured as closed-end limited partnerships with finite lives, typically 10 to 15 years, which encompass three phases: fundraising, investment, realization.

Regardless of the type of investment, investors should seek legal advice when reviewing the terms of investment agreements and structuring investments in order to meet their objectives.

**Portfolio Construction**

Another key difference between private and public equity involves portfolio construction. Due to illiquidity and other factors, unlike public market investments, an allocation to private equity cannot be implemented immediately or fine-tuned regularly with periodic rebalancings of the portfolio. Accordingly, the portfolio construction process should be undertaken with a long-term view and should balance quantitative analysis with judgment.

The first step in portfolio construction is to develop a plan. An investment plan establishes boundaries, develops investment criteria, discusses risk tolerance and outlines overall investment objectives for the private equity portfolio. The investment planning phase also encompasses determining an appropriate investment pace, or the amount of capital an investor should commit annually to private equity funds in order to reach their target allocation over a given horizon.

The next step is to implement the plan. As discussed, implementation in private equity is ongoing since funds call capital for investments and subsequently return the proceeds from realized deals over a typical ten year life. Sophisticated investors try to see as many investment opportunities as possible in order to be selective in choosing among the best opportunities that are in the market at any given point.

**Due Diligence**

Because success in private equity is largely dependent on manager selection, the process for evaluating managers is critical. As in traditional asset classes, the objective is to identify skilled investors with attractive track records. However, because private equity is an unregulated industry, investors should spend time evaluating the character of investment team members, the relevance of their prior experience and the team’s history of working together. This is accomplished through extensive interviews with team members and interviews with third party references. As well, investors should carefully evaluate the firm’s back office resources to ensure the manager is capable of timely and informative reporting and sufficient cash administrative services.
Legal
Each private equity fund investment is governed by a separate contract between the investor and the fund manager. So investors should seek assistance in reviewing and structuring an agreement that conforms with their objectives. Specific areas that should be considered in the legal review process include:

- **Fees**
- **Conflicts of interest**
- **Investment limitations and restrictions**
- **Key person provisions**

Monitoring & Administration
Another key difference between private and public equity involves the administration of investments, specifically cash flow management and performance monitoring and reporting.

Broadly, there are two types of cash flows in private equity: (1) capital called from investors for new investments or fees and (2) capital distributed to investors from realized investments, dividends or interest. Private equity cash flows are variable and generally not predictable, with limited advanced notice of capital calls and distributions. Fund administrators are required to have procedures in place to accommodate these cash flows reliably and efficiently.

There are also unique challenges associated with monitoring portfolio performance since private equity is unregulated and no standards exist for valuing investments in privately held companies. Typically, private equity investments are carried at cost until a formal appraisal or transaction (i.e., subsequent financing or a private or public sale) results in the realization of a gain or loss on the initial investment. Consequently, short-term performance measurement provides little meaningful information.

Investors can assess other factors that will yield insights on the health of a private equity portfolio. For instance, many managers provide quarterly or annual portfolio reviews, which detail the progress of unrealized portfolio companies in terms of revenue and profitability growth. Further, investors can monitor the consistency of the types of companies in a portfolio with the manager’s experience or stated investment strategy, as well as additions to or departures from the manager’s investment team, which may impact the fund.
Fees
Private equity is an expensive asset class. Funds are generally structured with an annual management fee ranging from 1.5% to 3.0%. During the investment period, the management fees are charged on total commitments. Once the investment period expires, the management fee typically “steps down” to a lower rate, which is assessed on net invested capital, or total invested capital less the cost of realized investments.

In addition to management fees, private equity fund managers are entitled to participate in the profits of investments. The profit participation, or carried interest, on most direct funds is 20%, though certain top tier venture fund managers charge 25% or 30% carried interest. Some FOF also charge management fees and carried interest, in addition to fees and carried interest charged by the underlying direct funds. The fees charged by private equity funds, while high, can be justified by the performance of the funds. However, as discussed earlier, this only highlights the importance of selecting funds that will deliver top quartile returns.

Private Equity Strategies
Private equity fund strategies can be segmented as outlined below, though terminology and classifications can vary by investor.

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Private Equity – Corporate Finance Strategies
- **Leveraged buyout** – Acquisitions of operating companies that are financed with equity and debt.

- **Growth capital** – Expanding companies in need of capital to finance high growth or acquisitions.

- **Turnaround** – Acquisitions of underperforming businesses or businesses in out-of-favor industries in need of either financial or operational restructuring.
Private Equity – Venture Capital Strategies

- **Early stage** – Companies that are in the process of developing business plans, products/services have been developed and are marketed to a limited number of customers.

- **Late stage** – High growth companies, nearing profitability.

Private Debt

- **Mezzanine** – Investments in subordinated debt issued by operating companies; frequently issued in conjunction with a buyout acquisition and with equity kickers attached, such as warrants or options in order to enhance returns.

- **Distressed debt** – Investments in public and private debt securities that are trading at discounts to par value due to financial stress of the underlying company.

- **Infrastructure** – Investments used to finance the construction or enhancement of distribution networks for electricity, water and gas, and certain transportation assets such as toll roads, bridges and tunnels.

State of the Private Equity Markets

2005 was one of the most active years in private equity history. Deal activity, purchase prices and financial leverage all trended higher in 2005.

The year was also strong for fundraising. The abundance of mega-buyout managers raising capital in 2005 drove global fundraising to over $222 billion, versus $133 billion raised in 2004.

U.S. and European buyout volume increased nearly 50% in 2005 from the 2004 level. The surge in deal activity was fueled by loose credit terms, large pools of private capital and the re-emergence of corporate acquirers.


Despite the favorable economic environment, venture-backed IPOs dropped in the U.S., due in part to burdensome Sarbanes-Oxley regulation.
**Outlook**
The pace of global investment activity will likely accelerate in 2006 given the larger pools of capital being raised.

Emerging markets, in particular China, India and Central Europe, will attract substantially more capital, as investors look to diversify from more efficient markets in the U.S. and Western Europe.

Purchase price multiples will remain high as borrowing costs remain low and buyout investors, corporate acquirers and hedge funds compete for deals.

Mega funds will continue to syndicate deals and move up market to even larger sized transactions.

Venture investment activity will remain reasonable in 2006 reflecting the moderate increase in venture fundraising. While information technology will continue to attract the most attention from venture capitalists, emerging industries alternative energy and nanotechnology will attract a bigger share of capital.

**Conclusion**
Private equity has experienced strong growth over the last two decades, and is likely to continue to grow as institutional investors seek higher-return alternatives to traditional asset classes.

As an asset class, private equity has delivered attractive returns for investors over the last two decades. As in the past, top managers will substantially outperform average managers, as well as the broad public market returns.

Investors should follow a regimented approach to the asset class, including developing and investment plan and guidelines, implementing the plan and carefully monitoring investment choices. Most importantly, investors should devote time and resources to identifying and accessing managers that are best positioned to generate top quartile returns.