The Economics of Private Equity

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1

What is Private Equity?

- Generally, refers to an investment structure comprised of a General Partner / Sponsor (GP) and Private Investors, or Limited Partners (LP's). They're "Private" as they're not listed on publicly traded exchanges and, generally, not open for investment by the general public – typically limited to Accredited Investors (this is a defined term by the SEC).
- Typically, LP's invest capital into one of two structures – a fund, or individual investments / small groups of similar investments.
- Private Equity Groups (PEG's) typically target specific asset classes – either operating companies in a specified industry or specific real estate asset classes.
- Typically, high risk, high reward (relative to traditional investments) investment structures. LP's act like creditors for a portion of their investment (preferred return) without traditional creditor rights and act like equity stakeholders in regards to residual profit splits.

2

Basic Roles of GP’s / LP’s

General Partners

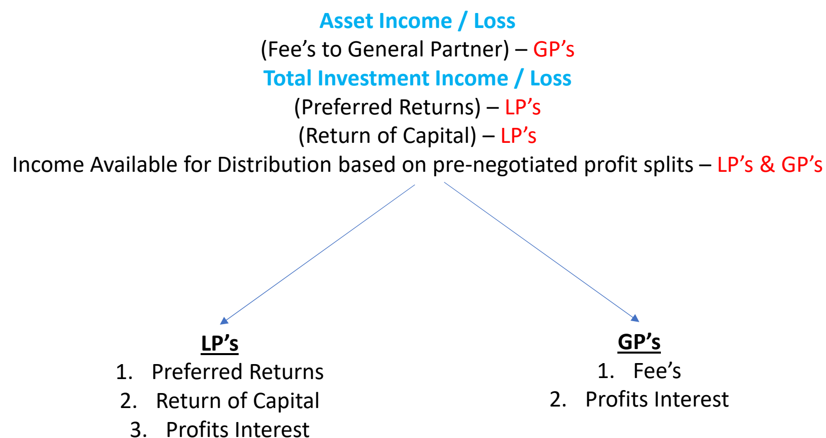
- Charged with overseeing and executing underlying investment. Often times, you will see them referred to as “sponsors” of an underlying investment. In it’s simplest form, the GP typically provides the “sweat equity” in executing an underlying investment.
- Typically compensated via fee’s charged to the underlying investment and a profit incentive
- Fee’s and profit incentive can vary deal by deal and are typically negotiated with/by investors
- GP’s may have a small % of capital in an underlying investment, or, none at all. This will vary investment by investment and is generally negotiated between the GP’s / LP’s

Limited Partners

- Generally provides the capital necessary to execute an underlying investment. Think of LP’s as the bridge between conventional financing and total funds required to execute.
- Typically compensated via a preferred return and profit incentive. Preferred return acts more like interest payments on debt without creditor rights.
- Very limited management / voting rights

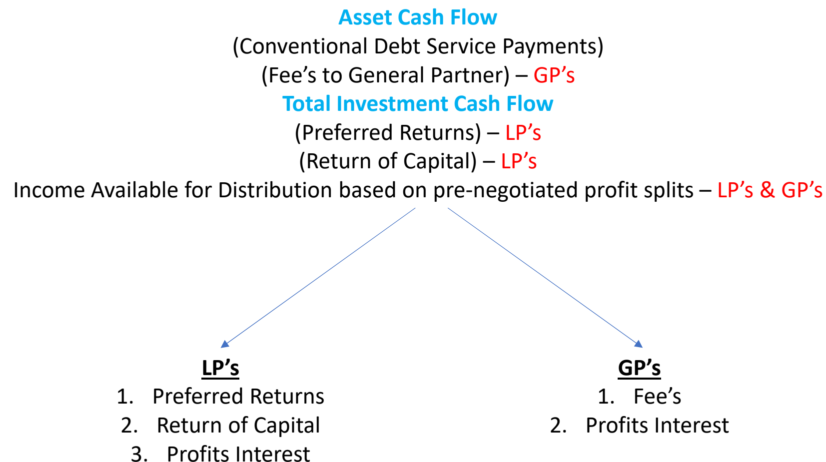
3

Typical Financial Model – PEG Investment



4

Typical Cash Flow Model – PEG Investment



5

Common Economic Investment Terms

CAUTION - Each of the terms below, if applicable, should be defined, along with the detailed calculation methodology, in the underlying operating agreements. However, I've attempted to generally define these terms based on what I've seen in common practice.

Fee's – These are paid to sponsors (GP's) before any preferred returns or profits allocations. Typically, this is a direct charge to the underlying investment entity just like any other operating expenses. Fee's should be well defined in the operating agreements and are typically a percentage of project costs, percentage of equity or percentage of total capitalization.

Sometimes, you'll see sponsors accrue fee's, or defer fee's to have it treated as a capital contribution, and subject the deferred fee's to the same rights as the LP investors. **Beware of GP's charging exorbitant fee's!**

Fee's will vary based on services being provided by the GP and are intended to compensate and provide cash flow to the GP to be able to maintain operations throughout the underlying investment.

Preferred Return – This is the amount promised to LP investors before any residual profit splits. Typically, the Preferred Return (Pref) accrues until capital is returned and is calculated as simple, or compounding, interest on capital invested until capital is returned.

Promote / Carried Interest – This is the proposed profit splits. Since LP's typically comprise 100% of the total equity raised, the GP is "promoted" up to a higher profits allocation than their equity contribution, on a pro-rata basis, would typically grant.

For example, you may see a GP contribute 5% of total equity but they may have a profits percentage of 30% once the preferred return and capital is returned. In theory, this is to incentivize the GP to achieve specific performance objectives over and above the preferred return.

6

Typical Investment Structure

A GP will typically market their underlying investment to prospective investors using terminology like – "we're offering an 8% Pref. with a 70/30 split". This would be an 8% preferred return with a 70% profits allocation to LP's and 30% allocation to GP's. However, these terms can vary wildly and are negotiated deal by deal.

A typical PE deal in commercial real estate will try to target somewhere between a 20% & 30% IRR to LP investors. In recent history, this has been a commensurate "market rate" where the potential returns are deemed to adequately compensate for the risk undertaken. Often, these assets are heavily leveraged to provide the cash flow necessary to achieve such. It's not uncommon for them to go through several rounds of financing to provide the cash flow to return capital to investors and stop the accrual of Pref as quickly as possible.

It's always important to ensure that the funds to the GP properly align the LP and GP financial interests. A GP that charges high fee's but is light on the promote may be financially motivated to keep the investment long term and not necessarily seek out the path to add the most value to the underlying investment. Alternatively, low / no fee's may make it prohibitive for the GP to be able to maintain operations to see the investment all the way through.

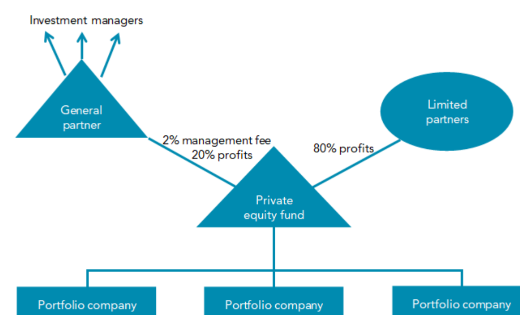
7

Funds Explained

Funds

- Typically have complex formulas to calculate economic rights as funds may have investors entering and exiting the funds at different times. This can make the waterfall allocations incredibly complex.
- Typically hold several investments meeting criteria detailed in the prospectus or PPM. Typically, specific projects are not identified until the capital has been committed.
- Capital is typically pre-raised on an "investment thesis" – once capital commitments have been secured, the GP will identify attractive assets and deploy capital. As capital is needed, GP will issue capital calls to LP investors.
- Funds typically have higher operational costs but provide flexibility to GP's in determining when / where to deploy capital.
- Ability to diversify / hedge – one underperforming asset unlikely to take down entire portfolio. Overperforming assets can help mask underperforming assets.

FIGURE 1
A Typical Private Equity Fund



8

Individually Syndicated Investments

Individual Investments

- Lower operating costs and simpler to manage
- Typically capital is raised for a specific project, already identified, during the capital round.
- Difficult to meet tight closing timetables – Raising capital while undergoing due diligence, receiving capital commitments, circulating OA's, lining up closing with capital funding. A lot of moving parts to synchronize.
- No, or little, diversification. If asset performs, great but if not, nothing to hedge against.

9