

Introduction to private equity

Institute of Actuaries - 5 April 2011

Introduction to private equity

Agenda

- What is private equity?
- The nature of private equity
- Benefits of private equity
- Fund of funds vs single funds
- Issues
- Summary
- Questions?

What is private equity?

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Private equity

- **Venture capital**
 - Seed capital
 - Early stage
 - Late stage
- **Buyout**
 - Buy out/buy in
 - Growth capital/Consolidation
 - Minority positions
 - Distressed/turnaround/restructuring
 - Leveraged buy outs - LBOs
- **Secondaries**

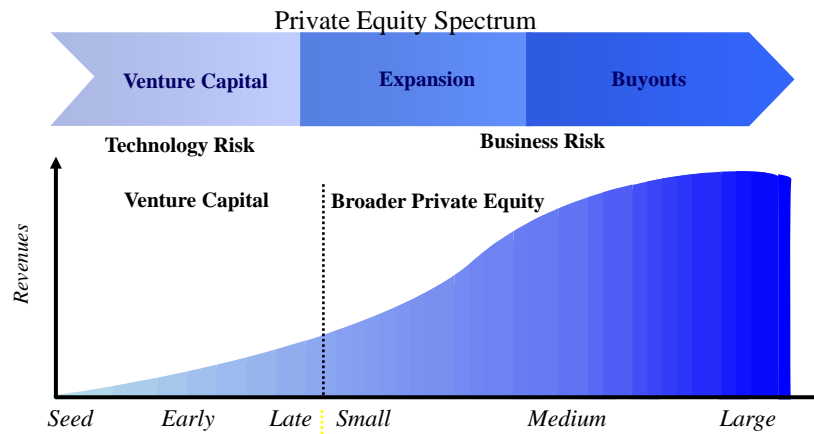
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Private debt

- Secured debt
- Banks debt
- Senior debt
- Mezzanine
- High yield
- Preference shares

Nature of private equity

Nature of private equity - Stages



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Nature of private equity

- Inefficient market
- Limited information on private deals
- Investment opportunity not widely known
- Vendors consider non-price related factors
- Manager provides expertise to company
- Full of jargon
- Buying investments with capital provided by investors
- New business plan leads to new structure
- Market position and track record built up
- Investment sold and proceeds distributed

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Illiquidity

- Require an accessible pool of money
- Time needed to build diversified portfolio
- Time for investments to reach maturity
- Cannot always divest at will
- Initial money flows out, followed by return of capital
- Open ended funds build new positions as old ones pay off

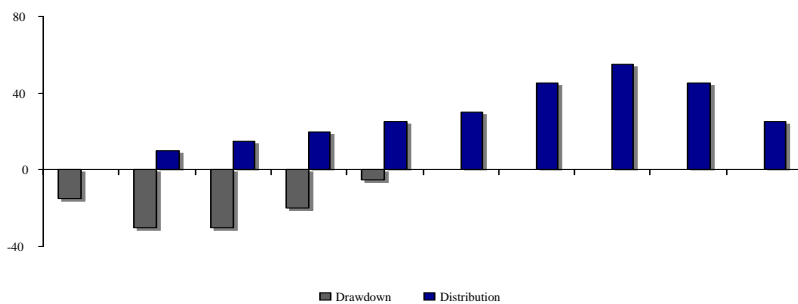
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Fund Structures

- **Limited partnerships**
 - Investors "commit" a set amount of money
 - Commitments drawn when opportunities arise
 - Money is distributed on realisations
- **Open ended funds**
 - Often listed
 - Initial lock-up
 - Limited liquidity

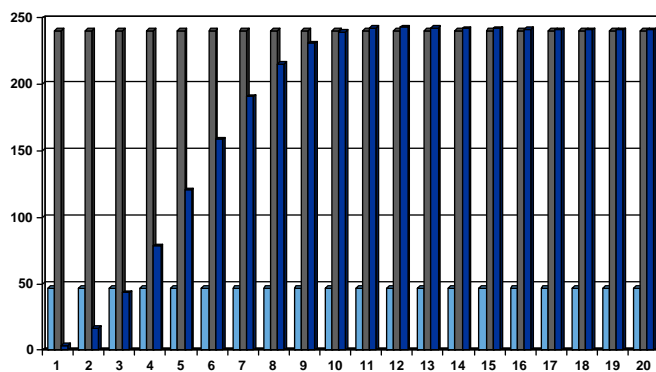
**Limited partnership cashflows
for a single \$100 million commitment**

Typical Cashflow Pattern

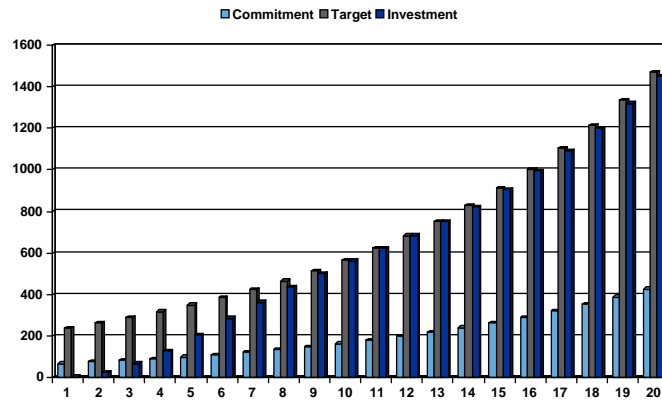


Standard build up of commitments to a flat \$240 million target

Commitment Target Investment



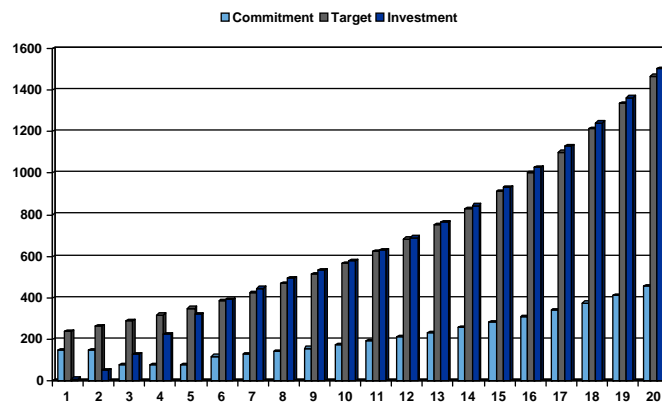
Standard build up of commitments to an increasing target



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Accelerated build up of commitments to an increasing target



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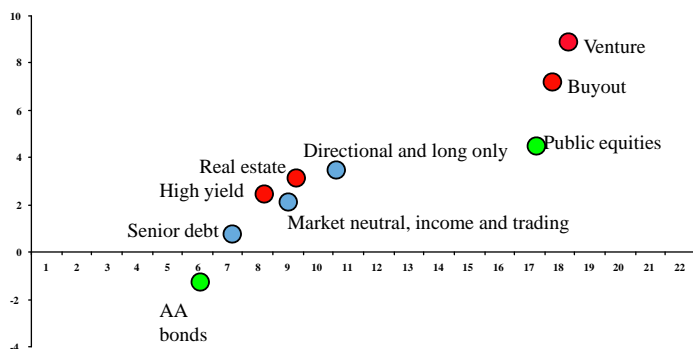
Fees

- **Venture Capital Funds**
 - 2% to 3% of committed capital
 - 20% to 30% carried interest (profit share)
 - Usually no hurdle
- **Buyout Funds**
 - 1.5% to 2% of committed capital
 - 20% to 30% carried interest
 - Usually an 8% hurdle
 - Catch-up once hurdle reached
- **Fund of funds - in addition to direct funds' fees**
 - 0.5% to 1.25% of committed capital
 - Up to 10% carry depending upon annual management fees

Benefits of private equity?

Why invest in private equity?

Risk return distributions of major alternative assets

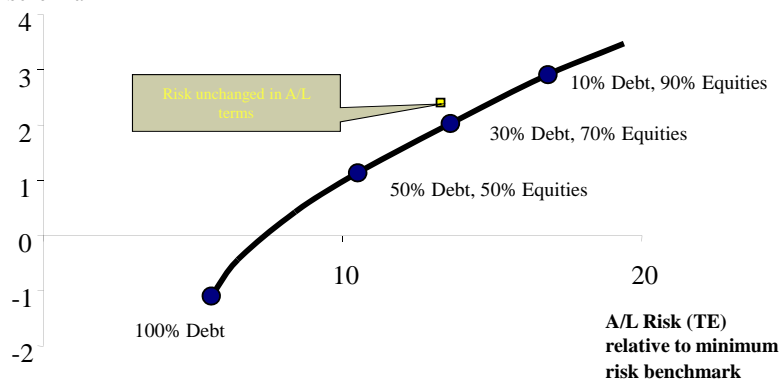


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Why invest in private equity?

A/L Return relative to minimum risk benchmark



Minimum risk benchmark is AA bond

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Key issues facing investors

- Falling yields
- Volatile equity markets
- Globalisation of markets
- Currency convergence
- Increased correlations

Plenty of challenges for fiduciaries

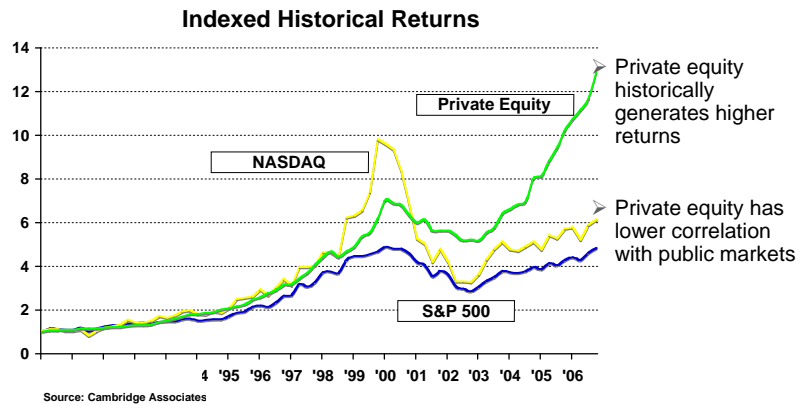
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Benefits of private equity

- Diversification
 - Smaller and different companies
 - Access to areas unavailable in public market
 - Access to a greater range of companies
- Potentially higher returns

Reduce risk & improve returns

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Potentially higher returns from private equity

- Compensation for illiquidity
- Information advantages
- Shareholder activism
- Meeting long-term objectives vs satisfying shareholder pressures
- Access to top quality management

Clear reasons for outperformance

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Fund of funds vs single funds

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Why fund of funds

- Access to funds
- Due diligence
- Portfolio construction
- Small investment sizes

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Why Single Funds?

- Additional fees on fund of funds
- Weight of money
- Greater control of investments
- Corporate links
- Use of specialist consultants for due diligence and legal

Market issues

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Access

- **Increasing available**
 - Traditionally a venture issue
 - Extended to buyouts
 - May return in mid market
 - Freedom of Information Act considerations
 - Minimum investment levels
- **Fund of funds**
 - Access varies from group to group
 - Ambiguities with pooled vehicles and direct investment arrangements
 - Level of access needs careful examination

Access is important but rarely clear

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Recent headlines

- **Mega buyout capital overhang**
- **Bank lending beginning to come back**
- **Difficulties in fund-raising**
- **Secondary sales beginning to come back**
- **Basle III**
- **Solvency II**

Game is changing

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Summary

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Summary

- **Fiduciaries are facing many demands**
- **Private equity can deliver higher returns and increase diversification**
- **Private equity is a non standard investment**
- **Issues can be practically managed**
- **A balanced portfolio takes time to build**
- **There are many areas of interest**
- **Single managers helps Fiduciaries control exposure**
- **Fund of funds help gain diversification and reduce work load**

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Questions?