

CFA LEARNING OUTCOMES DECODED

In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. Nicki DeGroot, CFA, the author of this article, works as a finance consultant and tutor for Tutor.com.

ALTERNATIVE INVESTMENTS: PRIVATE CAPITAL, REAL ESTATE, INFRASTRUCTURE, NATURAL RESOURCES, AND HEDGE FUNDS

LOS: Explain investment characteristics of private equity

This LOS describes one of the most popular alternative investment strategies. The candidate must understand the common investment and exit strategies for private equity as these are highly testable concepts.

Private equity represents an investment in a private firm. It is perhaps better described by what it is not, that is, it is not an investment in a public company or debt. Private equity investments are undertaken by private equity firms that also invest in other assets. The investments are often held in funds, with each private equity fund having multiple investments, separately called a portfolio company. Common strategies for taking a private investment include leveraged buyouts and venture capital.

Leveraged Buyouts

A leveraged buyout transaction results when an existing company is acquired by a private equity firm with the purchase funded by a large percentage of the debt. The acquired company often has a large asset base to use as collateral for the debt, a low amount of debt prior to the sale, and strong cash flows to service the debt. The private equity firm may replace management if it feels it can better run the business, called a “management buy-in,” and these are often hostile transactions. Or if management is involved, it would be termed a “management buyout”. Financial returns depend on cheap and easily placed debt to fund the transaction and the ability to restructure the company.

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Venture Capital

New or start-up companies are typically still private, and investments to help these companies grow fall under the venture capital category. A successful venture capital investment depends on an effective management team. The earlier the stage of the investment, the likely higher returns demanded due to the risk of success. As the start-up companies grow, investments track the following stages:

- Angel investing, or pre-seed capital starts with just an idea
- Seed capital is used for market research and to fund product development
- Early-stage capital often finances the start of operations leading to initial production and early sales, but not yet the commercial production phase
- Later-stage financing typically supports expansions such as plant additions, increased marketing, or improvements in production
- The mezzanine stage occurs just before the initial public offering (IPO) and is categorized more on the timing of the investment than the purpose of the funding

Exit strategies

A private management firm ultimately seeks to exit the transaction and lock in the return. Popular exit strategies include:

- Trade sale to a strategic buyer, perhaps a competitor of the portfolio company
- Secondary sale to other investors or another private equity firm
- Initial public offering (IPO), where shares are sold to the public

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- A special purpose acquisition company (SPAC) is a public shell company that merges with the portfolio company to create a public company as an alternative to an IPO
- A recapitalization increases the company's debt load, generating funds that may be used to cash out a portion of the company's equity or to pay out a special dividend
- Write-off or liquidation when the investment performs poorly and the parts of the company are sold off or written down

Interest in private equity has grown over time. Investors can participate via investing in a private equity fund, fund of funds, co-investment, or direct investment. Private equity firms generally use limited partnership structures and collect fees on committed capital plus incentive fees on returns. The historical performance of these funds is difficult to observe given the lack of public information available. Generally, investors should demand higher returns due to the illiquidity and increased risks of private investments.

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PRACTICE QUESTION

A private equity firm, Top Capital, recently invested in a new probiotic company to support a plant expansion and a new marketing campaign. Top Capital expects to hold the investment for 3–5 years before shares are sold to the public. The type and exit strategy of this investment are *most likely* classified as which of the following?

- A. Leveraged buyout and a special purpose acquisition company
- B. Mezzanine stage funding and trade sale
- C. Venture capital and initial public offering

C is correct. An investment to support a plant expansion and new marketing campaign would be a form of venture capital and occurs as later-stage financing before the mezzanine stage. Exiting when shares are sold to the public describes an initial public offering (IPO).