

# NAVIGATING PRIVATE EQUITY

INVESTING IN PRIVATE MARKETS



# INTRODUCTION

Private equity (PE) invests in private companies (not publicly traded or listed) in exchange for equity or ownership. Also, public companies can occasionally be acquired, made private or de-listed. In contrast to public equity investments, which trade daily, private equity investments are long-term and illiquid.

Private equity is a key source of capital for innovative companies and therefore well-placed to provide investors with access to a broad range of growth themes - including 5G, fintech, health-tech, and green-tech. It can sometimes be a more effective way of gaining exposure to growth companies since pure exposure to earlier-stage businesses can be hard to achieve in public markets.

## PRIVATE EQUITY STRATEGIES

Private equity funds can invest and specialise in various stages of company life cycles. These tend to have different risk and return drivers and require different skill sets from the manager.

### Venture Capital (VC)

Targets investments in promising start-ups. VC investors provide seed funding for a share in the business that is at an early stage of growth. Usually, it happens even before the company starts generating profits, coupled with high cash burn, which leads to high volatility and unpredictability of outcomes. In return, if successful, VC deals can provide high returns.

### Growth Stage

Investing occurs further into the life of a company, which is well-established, but its continued growth would benefit from additional funding. Again, the investment is with an equity stake, but where there are far more company financials to analyse and products to evaluate the company's value. As a result, the volatility here is usually lower than investing in VC stages.

### Buyouts

The companies being targeted here are mature, often public with a view to utilising private equity funding and skills to turnaround the business and develop further growth.



# PRIVATE EQUITY ACCESS FOR INVESTORS

## Private equity single funds

They provide access to a diversified exposure of underlying companies. Funds can have a broad and diverse strategy or focus on specific geographies, sectors, or themes.

## Private equity fund of funds (FoF)

Private equity fund of funds invest in a variety of private equity single funds. Strategy definition and manager selection are very important to derive a diversified set of top-tier managers. FoF investments can be spread across vintages, strategies, geographies and sectors to varying degrees.

## Direct co-investments

Direct co-investment opportunities are sometimes offered by fund managers (general partners – GPs) to investors (limited partners – LPs) to invest alongside in specific deals. The general control over managing the investment stays with the GP. GPs tend to offer these opportunities selectively to certain LPs they have a long-standing relationship with.

## LIFECYCLE OF A PRIVATE EQUITY FUND

The process starts with promoting the fund to potential investors, who will then commit capital (Figure 1).

Once the fund reaches its target size or predetermined closing date, it enters the investment period. During this phase, the fund begins deploying capital, issuing capital calls to investors based on the specific amounts needed\*. It is common during this time to observe a netting of cash flows, as exits can already happen during this investment period. Money from distributions can be netted with money needed for new investments. As the fund matures, the frequency and size of distributions typically increase, eventually surpassing the capital being called. Toward the end of the fund's lifecycle, usually around 10 years, the focus shifts to realising investments and returning capital to investors. After this stage, there is the possibility of an extension period, if the fund was not able to realise or exit investments on favourable terms.

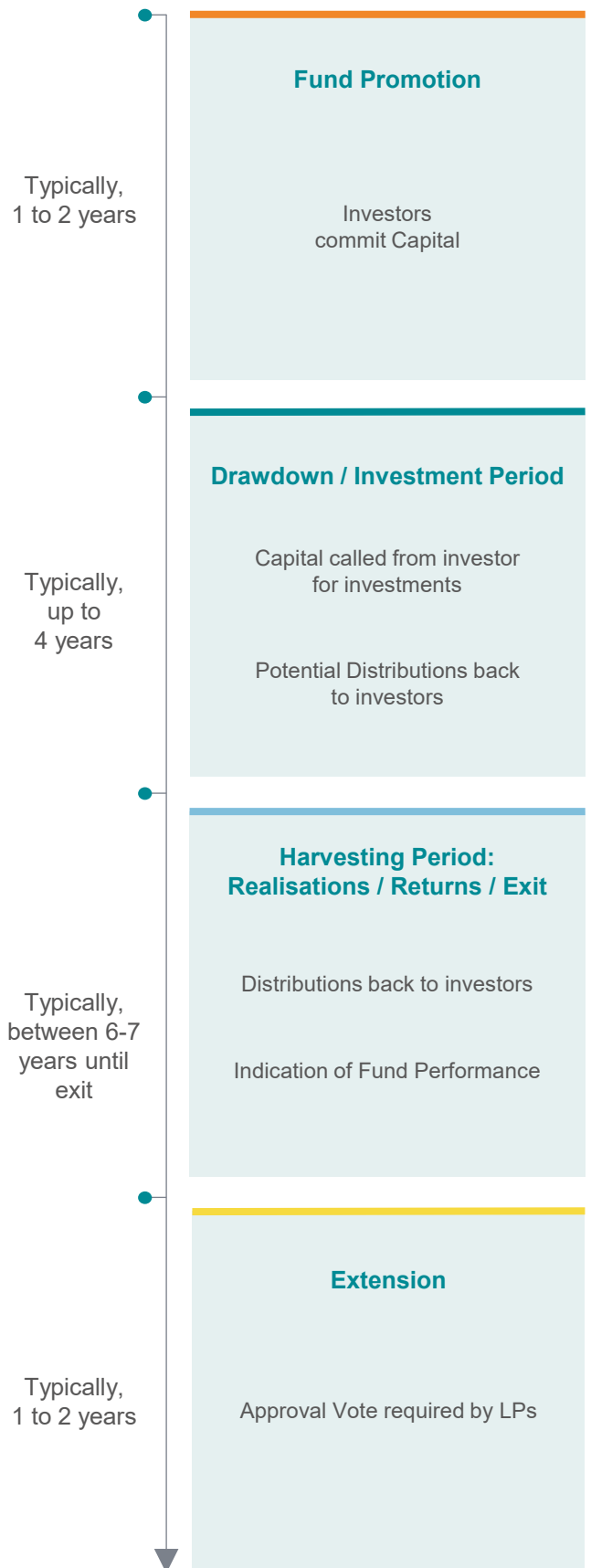


Figure 1: Life cycle of a private equity fund

\*Some funds can be fully funded, meaning they call all the committed capital at once when the subscription is made



## PRIVATE EQUITY FEES

The fees of a private equity fund are usually split between management and performance fees.

**Management fees**, generally a flat fee of around 2% calculated on committed capital. **Performance fees**, generally a percentage of profits of 15-20%.

While performance fees may seem high, even more so if the fund performs well, these can incentivise managers to perform better.

Private equity fund of funds (FOF) usually have a **double layer of fees** (fees for the FoF itself and for underlying funds). Larger investors with dedicated resources may prefer building their own portfolio to avoid fee compounding.

## WHY INVEST IN PRIVATE EQUITY?

### High absolute returns

In order to achieve high returns, simply put private equity investors aim to buy low and sell high. Once a business has been acquired, operational improvements can be made to increase its value prior to exit. Private companies tend to be smaller and cheaper to buy since they are not easily sold or valued – hence the greater absolute return.

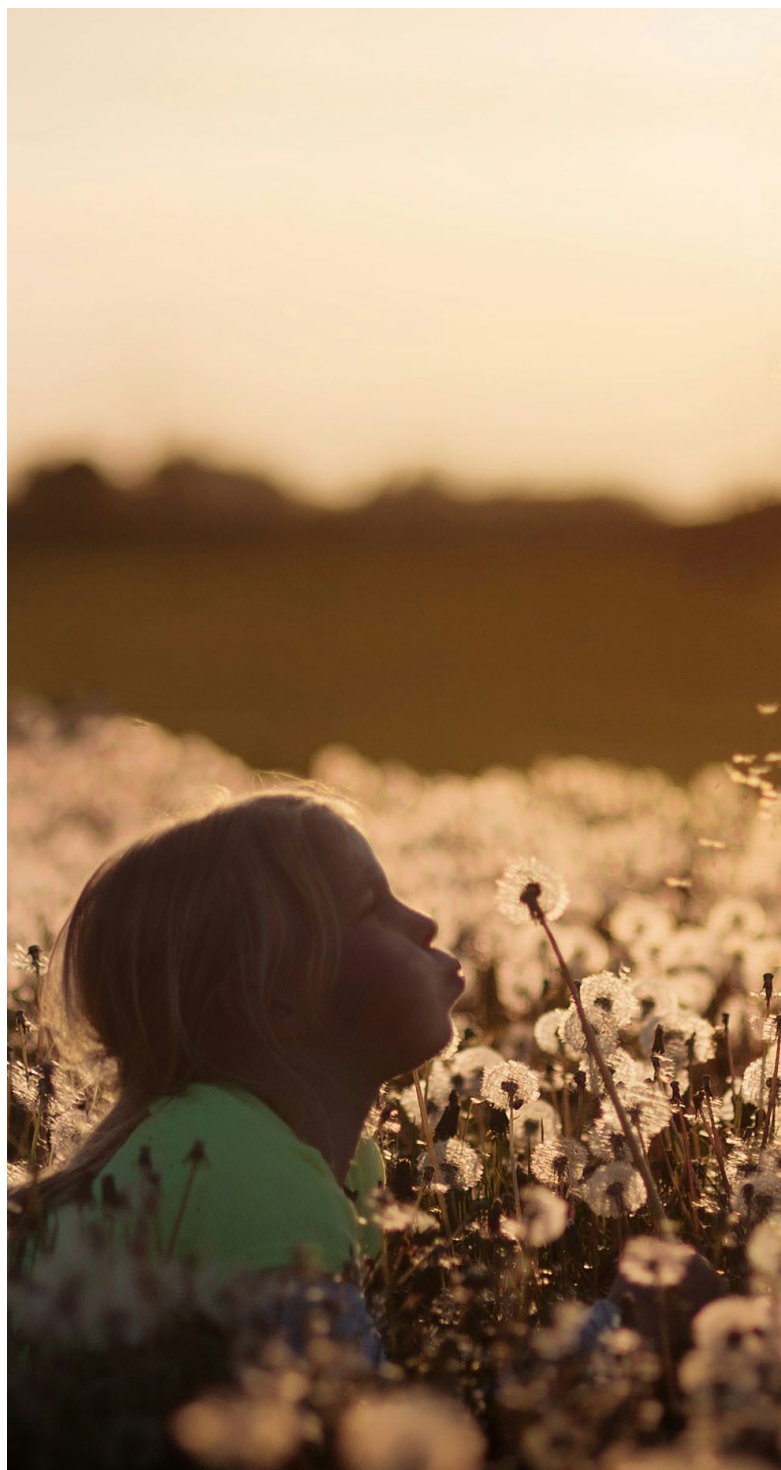
As in public equity, investors in private equity are subject to market risk, credit risk, and operational risk, but they also carry additional risks due to the illiquidity of underlying assets. As a result, investors expect a higher return for their private equity investments relative to those in stocks or bonds.

### High risk-adjusted returns

Risk-adjusted returns are measured by comparing the level of risk involved in the investment and its subsequent return. An investor analyses financial, credit, market, and operational risks to generate the potential risk factor. Often, the returns within this asset class, while risk-adjusted, are higher than for traditional investments.

## Diversification

Private equity offers portfolio diversification benefits for investors through low correlation to public markets. Another benefit is that investors are allocating to funds which invest in a variety of companies. Through these funds investors gain access to different industry sectors within private equity and different geographies as well.



## RISKS AND CONSIDERATIONS

As with all investments, private equity is not without risks. Private equity investments are not suitable for all investors and there is the risk of a loss of principal. Additional risks associated with private equity include, but are not limited to, liquidity risks, limited secondary market, management risk, concentration and non-diversification risks, foreign investment risks, risks associated with a lack of transparency, leverage risks, volatility risks and macro risks.

## CONCLUSION

The addition of private equity to an existing multi-asset portfolio may:

- Enhance the portfolio quality and asset diversification and therefore improve risk-adjusted returns.
- Broaden the opportunity set and investment universe.
- Harvest illiquidity premium for committing capital to longer lockup strategies and integrate an impact premium, where possible.
- Ability to use additional levers (e.g., leverage, operational improvements).



### Let's talk

We hope this has been a helpful overview of Private Markets.

Take the next step and talk to one of our Client Advisors to discover how Brown Shipley can help you.

**Get in touch.**

**Visit [brownshipley.com/contact](https://brownshipley.com/contact).**

#### Important Information

- Investing puts your capital at risk.
- The value of your investments or any income from them can go down as well as up, and you could lose some or all of the money.
- Alternative investments are illiquid, high risk and not suitable for all investors.

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