EXHIBIT B

Private Equity

By JAMES CHEN | Reviewed By GORDON SCOTT | Updated Feb 6, 2020

What is Private Equity?

Private equity is an alternative investment class and consists of capital that is not listed on a public exchange. Private equity is composed of funds and investors that directly invest in private companies, or that engage in buyouts of public companies, resulting in the delisting of public equity. Institutional and retail investors provide the capital for private equity, and the capital can be utilized to fund new technology, make acquisitions, expand working capital, and to bolster and solidify a balance sheet.

Advertisement

Advertisement

A private equity fund has Limited Partners (LP), who typically own 99 percent of shares in a fund and have limited liability, and General Partners (GP), who own 1 percent of shares and have full liability. The latter are also responsible for executing and operating the investment.

Advertisement

Advertisement

Understanding Private Equity

Private equity investment comes primarily from institutional investors and accredited investors, who can dedicate substantial sums of money for extended time periods. In most cases, considerably long holding periods are often required for private equity investments in order to ensure a turnaround for distressed companies or to enable liquidity events such as an initial public offering (IPO) or a sale to a public company.

Advantages of Private Equity

Private equity offers several advantages to companies and startups. It is favored by companies because it allows them access to liquidity as an alternative to conventional financial mechanisms, such as high interest bank loans or listing on public markets. Certain forms of private equity, such as venture capital, also finance ideas and early stage companies. In the case of companies that are de-listed, private equity financing can help such companies attempt unorthodox growth strategies away from the glare of public markets. Otherwise, the pressure of quarterly earnings dramatically reduces the time frame available to senior management to turn a company around or experiment with new ways to cut losses or make money.

investment of company. Second, pricing of shares for a company in private equity is determined through negotiations between buyers and sellers and not by market forces, as is generally the case for publicly-listed companies. Third, the rights of private equity shareholders are generally decided on a case-by-case basis through negotiations instead of a broad governance framework that typically dictates rights for their counterparts in public markets.

History of Private Equity

While private equity has garnered mainstream spotlight only in the last three decades, tactics used in the industry have been honed since the beginning of last century. Banking magnate JP Morgan is said to have conducted the first leveraged buyout of Carnegie Steel Corporation, then among the largest producers of steel in the country, for $480 million in 1901. He merged it with other large steel companies of that time, such as Federal Steel Company and National Tube, to create United States Steel – the world's biggest company. It had a market capitalization of $1.4 billion. However, the Glass Steagall Act of 1933 put an end to such mega-consolidations engineered by banks.

Private equity firms mostly remained on the sidelines of the financial ecosystem after World War II until the 1970s when venture capital began bankrolling America's technological revolution. Today's technology behemoths, including Apple and Intel, got the necessary funds to scale their business from Silicon Valley's emerging venture capital ecosystem at the time of their founding. During the 1970s and 1980s, private equity firms became a popular avenue for struggling companies to raise funds away from public markets. Their deals generated headlines and

When it took place in 1988, conglomerate RJR Nabisco's purchase by Kohlberg, Kravis & Roberts (KKR) for $25.1 billion was the biggest transaction in private equity history. It was eclipsed 19 years later by the $45 billion buyout of coal plant operator TXU Energy. Goldman Sachs and TPG Capital joined KKR in raising the required debt to purchase the company during private equity's boom years between 2005 and 2007. Even Warren Buffett bought $2 billion worth of bonds from the new company. The purchase turned into a bankruptcy seven years later and Buffett called his investment "a big mistake."

The boom years for private equity occurred just before the financial crisis and coincided with an increase in their debt levels. According to a Harvard study, global private equity groups raised $2 trillion in the years between 2006 and 2008 and each dollar was leveraged by more than two dollars in debt. But the study found that companies backed by private equity performed better than their counterparts in the public markets. This was primarily evident in companies with limited capital at their disposal and companies whose investors had access to networks and capital that helped grow their market share.

In the years since the financial crisis, private credit funds have accounted for an increasing share of business at private equity firms. Such funds raise money from institutional investors, like pension funds, to provide a line of credit for companies that are unable to tap the corporate bond markets. The funds have shorter time periods and terms as compared to typical PE funds and are among the less regulated parts of the financial services industry. The funds, which charge high interest rates, are also less affected by geopolitical concerns, unlike the bond market.

- Distressed funding: Also known as vulture financing, money in this type of funding is invested in troubled companies with underperforming business units or assets. The intention is to turn them around by making necessary changes to their management or operations or make a sale of their assets for a profit. Assets in the latter case can range from physical machinery and real estate to intellectual property, such as patents. Companies that have filed under Chapter 11 bankruptcy in the United States are often candidates for this type of financing. There was an increase in distressed funding by private equity firms after the 2008 financial crisis.
- Leveraged Buyouts: This is the most popular form of private equity funding and involves buying out a company completely with the intention of improving its business and financial health and reselling it for a profit to an interested party or conducting an IPO. Up until 2004, sale of non-core business units of publicly listed companies comprised the largest category of leveraged buyouts for private equity. The leveraged buyout process works as follows. A private equity firm identifies a potential target and creates a special purpose vehicle (SPV) for funding the takeover. Typically, firms use a combination of debt and equity to finance the transaction. Debt financing may account for as much as 90 percent of the overall funds and is transferred to the acquired company's balance sheet for tax benefits. Private equity firms employ a variety of strategies, from slashing employee count to replacing entire management teams, to turn around a company.
- Real Estate Private Equity: There was a surge in this type of funding after the 2008 financial crisis crashed real estate prices. Typical areas where funds are deployed are commercial real estate and real estate investment trusts (REIT). Real estate funds require higher minimum capital for investment as compared to other funding categories in private equity. Investor funds are also locked away for several years at a time in this type of funding. According to research firm Preqin, real estate funds in private equity are expected to clock in a 50 percent growth by 2023 to reach a market size of $1.2 trillion.
- Fund of funds: As the name denotes, this type of funding primarily focuses on investing in other funds, primarily mutual funds and hedge funds. They offer a backdoor entry to an investor who cannot afford minimum capital requirements in such funds. But critics of such funds point to their higher management fees (because they are rolled up from multiple funds) and the fact that unfettered diversification may not always result in an optimal strategy to multiply returns.

other hand, early stage financing can help an entrepreneur grow a company further while a Series A financing enables them to actively compete in a market or create one.

How Do Private Equity Firms Make Money?

The primary source of revenue for private equity firms is management fees. The fee structure for private equity firms typically varies but usually includes a management fee and a performance fee. Certain firms charge a 2-percent management fee annually on managed assets and require 20 percent of the profits gained from the sale of a company.

Positions in a private equity firm are highly sought after and for good reason. For example, consider a firm has $1 billion in assets under management (AUM). This firm, like the majority of private equity firms, is likely to have no more than two dozen investment professionals. The 20 percent of gross profits generates millions in firm fees; as a result, some of the leading players in the investment industry are attracted to positions in such firms. At a mid-market level of $50 to $500 million in deal values, associate positions are likely to bring salaries in the low six figures. A vice president at such a firm could potentially earn close to $500,000, whereas a principal could earn more than $1 million.

KEY TAKEAWAYS

- Private equity is an alternative form of private financing, away from public markets, in which funds and investors directly invest in companies or engage in buyouts of such companies.
- Private equity firms make money by charging management and performance fees from investors in a fund.
- Among the advantages of private equity are easy access to alternate forms of capital for entrepreneurs and company founders and less stress of quarterly performance. Those advantages are offset by the fact that private equity valuations are not set by market forces.
- Private equity can take on various forms, from complex leveraged buyouts to venture capital.

PART OF
2020 Election Guide

regulations allowing for a bigger window into the inner workings of private equity firms. However, lawmakers on Capitol Hill are pushing back, asking for limitations on the Securities and Exchange Commission's (SEC) access to information.

Day trading "starter kit."

Learn to create a trading plan with Investopedia Academy's "Become A Day Trader." This online course is taught by an actual Wall Street Trader, includes a step-by-step playbook for 6 trades you can use right away, and takes less than a day to complete. Watch free trailer > >

Compare Accounts

Advertiser Disclosure

IG	Merrill Edge	Charles Schwab
Trade with Investopedia's Best Forex Broker in 2019. FX spreads from 0.8 pips	Get up to $600 when you invest in a new Merrill Edge Self-Directed account	$0 online stock, ETF, and options commissions at Schwab.
LEARN MORE	LEARN MOR	LEARN MOR

Related Terms

Permanent Capital Vehicle (PCV) Definition

A permanent capital vehicle (PCV) is an investment entity for managing permanent or evergreen capital. more

Venture Capitalist (VC) Definition

Investopedia

long-term growth potential. more

What Is Capital?

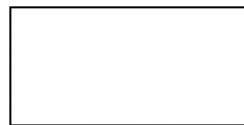
Capital is a financial asset that usually comes with a cost. Companies report capital on the balance sheet and seek to optimize their total cost of capital. more

Club Deal

A club deal is a private equity buyout or the assumption of a controlling interest in a company that involves several different private equity firms. more

Carried Interest Definition

Carried interest is a share of any profits that the general partners of private equity and hedge funds receive as compensation. more



Partner Links

Take on the markets w/ confidence. E*TRADE's easy to use tools help make trading quicker & simpler.

Get access to TD Ameritrade's free education with videos, articles, and more.

Sign up for our daily newsletters

Related Articles

PRIVATE EQUITY & VENTURE CAP

World's Top 10 Private Equity Firms

Investopedia

PART OF
2020 Election Guide

The Biggest Private Equity Firms in Los Angeles (OAK, KYN)

COMPANY PROFILES
The 4 Biggest Private Equity Firms in London

ACCOUNTING
Grasp the Accounting of Private Equity Funds

RICH & POWERFUL
How Henry Kravis Built Private Equity Giant KKR

PRIVATE EQUITY & VENTURE CAP
Understanding Private Equity Fund Structure

Investopedia

TRUSTe

Investopedia

PART OF
2020 Election Guide

California Privacy Notice | News

Terms of Use | Careers

Investopedia is part of the Dotdash publishing family.