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PRIVATE EQUITY

Innovation and Evolution

By Anthony B. Davidow, CIMA®



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With the recent flurry of initial public offerings—including Uber, Lyft, Beyond Meat, and Pinterest, to name a few—many investors have turned their focus to private equity. Regardless of how these companies perform once they go public, their early investors often reap very big rewards.

Historically, it has been very difficult to invest in these early-stage companies. Given the tremendous advancements in product structure, however, private equity is now more accessible to investors at lower minimums with greater liquidity.

This article explores opportunities in private equity and delves into the innovation and evolution in product development, including the following:

Today there are more private companies than public companies. The number of U.S.-listed companies has fallen from 7,322 in 1996 to around 4,000 today. By comparison, there are more than 6 million private companies.

- What is private equity?
- What are some key considerations for investors?
- Why is now potentially a good time to invest in private equity?
- How can investors access private equity opportunities?
- What's next?

U.S.-listed companies has fallen from 7,322 in 1996 to around 4,000 today (Veronis and Esipovich 2019). By comparison, there are more than 6 million private companies (Rasmussen 2017). Many of these companies now stay private longer, and some will never go public.

The appeal of private equity has long been the opportunity to reap outside returns and possibly identify the next Apple, Google, or Facebook.

WHAT IS PRIVATE EQUITY?

Today there are more private companies than public companies. The number of

Figure 1

STAGES OF PRIVATE EQUITY

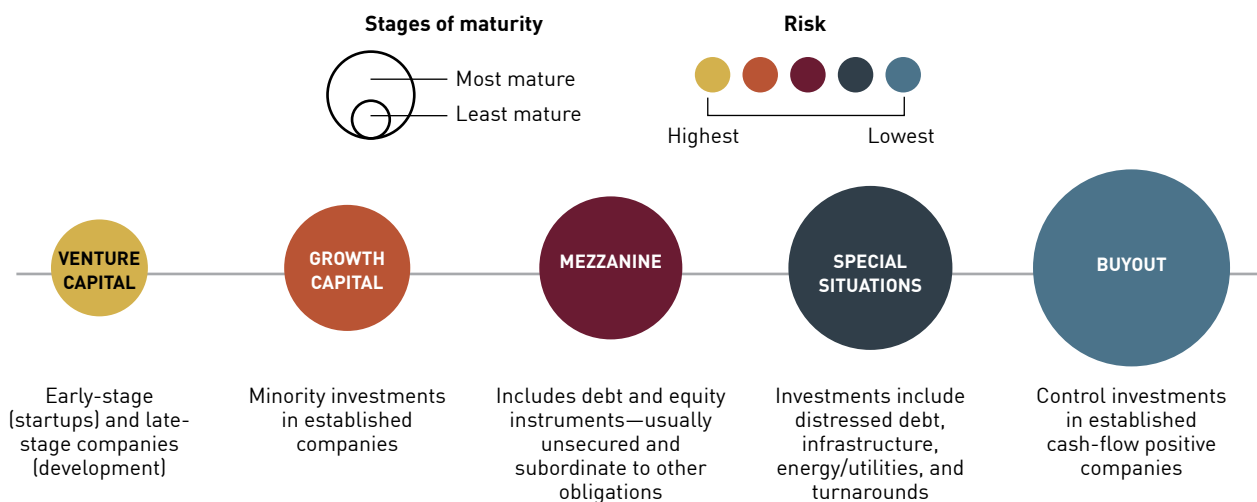
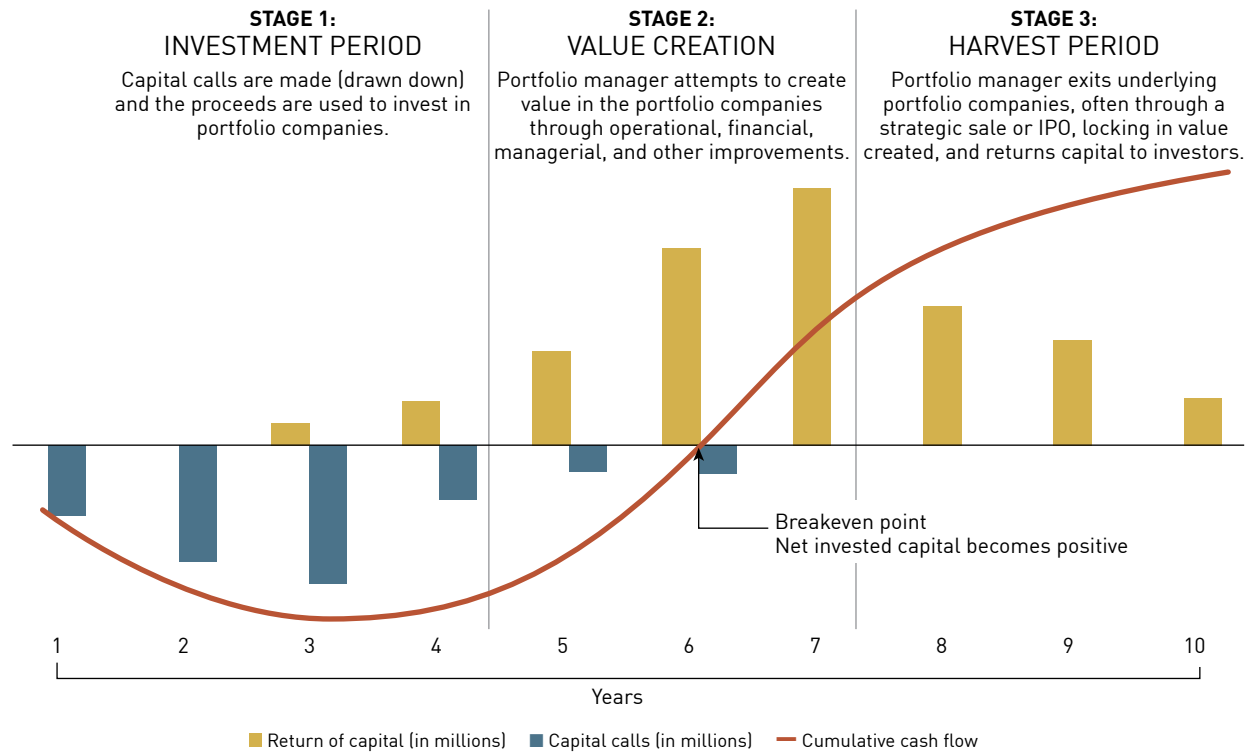


Figure
2

LIFE CYCLE OF PRIVATE EQUITY FUNDS



Source: Schwab Center for Financial Research with data provided by Pantheon. This is a simplified hypothetical example, and does not represent the performance of an actual company or fund.

Although many investors focus on the “unicorns”—those rare startup companies with valuations of more than \$1 billion—the reality is that private equity often represents early-stage companies from venture capital to buyout (see figure 1).

In recent years, we’ve seen well-established companies going private, and companies remaining private much longer than in the past. Many private companies are no longer growing with the sole purpose of going public. According to Nasdaq Private Market, venture capital investment in primary offerings reached an all-time high in 2018 at \$131 billion, almost three times the money raised via initial public offerings (\$47 billion) (Paart 2019).

WHAT ARE KEY CONSIDERATIONS FOR INVESTORS?

Investors should consider the risks associated with investing in these early-stage companies. First, there is a risk that some of these companies will fail.

Even if the company succeeds, investors need to be patient because it may take several years for investors to see a return on their capital.

It’s important to understand the life cycle of private equity funds (see figure 2). If you invest in a publicly traded company, the investment will fluctuate based on company fundamentals and growth potential. If you’re dissatisfied with a public company, you can easily sell your investment in the open market and deploy your capital elsewhere.

In private equity funds, money is drawn down over time and capital is deployed as the fund sources opportunities. This is often referred to as the “J curve.” In the early stage, capital is drawn down. As opportunities are sourced and capital is deployed, investors gradually begin to see a positive return leading up to the harvest period. Consequently, private equity investors should have a long-term time horizon (typically seven to 10 years).

Investors may want to consider diversification across private equity opportunities to mitigate some of the risks. Potential types of diversification are as follows:

- Stage
- Geography
- Industry
- Vintage
- Manager

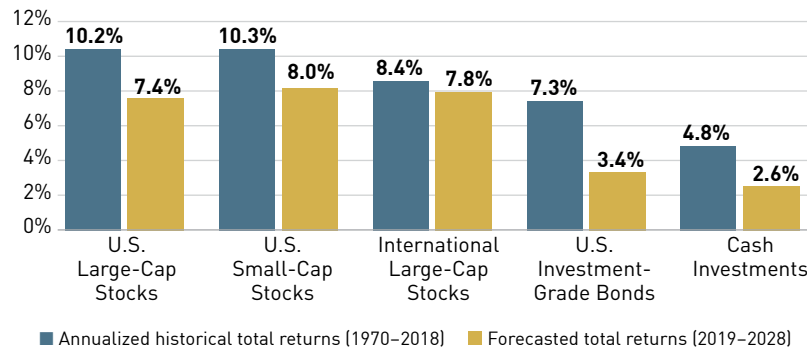
Today, investors can gain diversified exposure to multiple private equity opportunities in various structures. We’ll cover product structure later in this article.

WHY IS NOW POTENTIALLY A GOOD TIME FOR PRIVATE EQUITY?

As we enter the late stages of this historic bull market, strategists at many companies are predicting a lower-return environment for traditional equities over the next several years (see figure 3 and Perianan 2019). If capital market

Figure 3

CAPITAL MARKET EXPECTATIONS FOR SELECT ASSET CLASSES



Total return equals price growth plus dividend and interest income. Numbers rounded to the nearest one-tenth of a percentage point. Benchmark indexes for the asset classes: S&P 500 Index® (U.S. Large Cap Stocks), Russell 2000® (U.S. Small-Cap Stocks), MSCI EAFE Index® (International Large-Cap Stocks), Bloomberg Barclays U.S. Aggregate Bond Index® (U.S. Investment-Grade Bonds), and Citigroup 3-Month U.S. Treasury Bill Index (Cash Investments). Past performance is no guarantee of future results.

Source: Capital Market Expectations data from Charles Schwab Investment Advisory, Inc. and affiliate; used with permission of Charles Schwab & Co. and does not represent any form of endorsement by Schwab. Historical data from Morningstar Direct. As of December 31, 2018.

expectations for traditional investments are likely to be lower in the future, then investors will need to find other sources of growth for their portfolios.

As shown in figure 4, private equity historically has offered higher returns and lower risk relative to many traditional investments. Private companies are able to invest for the future, and they aren't answering to shareholders evaluating short-term results. They can take a long-term approach to executing strategy rather than focusing on quarterly earnings and how markets will respond to the numbers.

Due to the favorable return characteristics and the projections for lower returns from traditional asset classes, many institutions and family offices have been increasing their allocations to private equity. (Note that private equity volatility is likely understated due to the manner and frequency of valuing the underlying assets.) Many of the largest investors and institutions have increased their exposure to private equity (see figure 5).

For example, the Yale endowment historically has allocated a significant portion of its portfolio to alternative investments broadly, and private equity specifically (see figure 6). Of course, Yale has a number of built-in advantages relative to the average high-net-worth or ultra-high-net-worth family. It has unique access due to its size, and its time horizon is perpetuity.

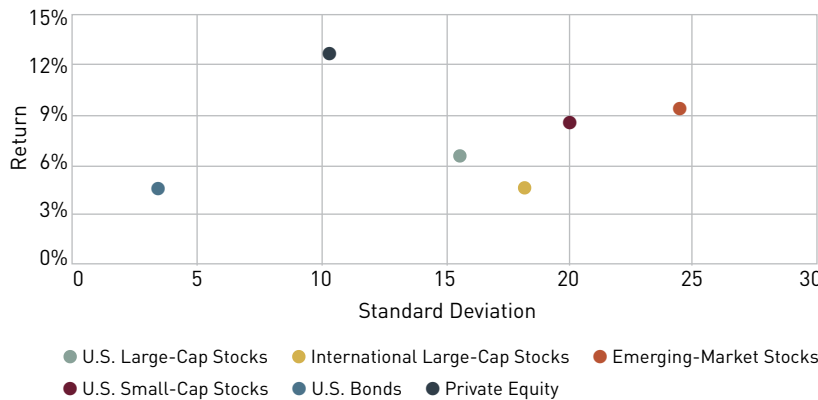
That said, if some of the best and the brightest investors are allocating such large amounts to an asset class, we shouldn't ignore it either.

HOW CAN INVESTORS ACCESS PRIVATE EQUITY OPPORTUNITIES?

Historically, private equity was available only to large institutions and very wealthy families. You often needed significant wealth to get access and adequate diversification. Accessing private equity was limited to working through

Figure 4

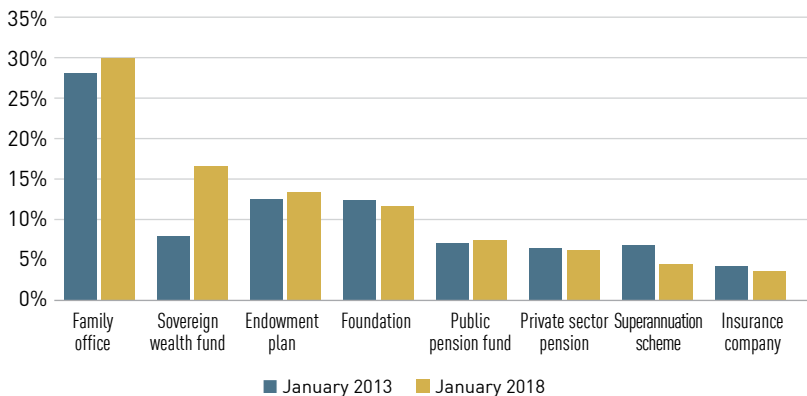
SELECT ASSET CLASS RETURNS (1999-2018)



Source: Schwab Center for Financial Research with data provided by Morningstar Direct. Data from January 1, 1999-December 31, 2018. Benchmark indexes for the asset classes: S&P 500 Index (U.S. Large-Cap Stocks), Russell 2000 Index (U.S. Small-Cap Stocks), MSCI EAFE Index (International Large-Cap Stocks), MSCI Emerging Market Index (Emerging-Market Stocks), Bloomberg Barclays U.S. Aggregate Bond Index (U.S. Bonds), Cambridge Associates U.S. Private Equity Index (Private Equity). Standard deviation is a measure that is used to quantify the amount of variation or dispersion of a set of data values. Past performance is no guarantee of future results.

Figure 5

AVERAGE TARGET PRIVATE EQUITY ALLOCATION BY INVESTOR TYPE AS A PERCENTAGE OF ASSETS UNDER MANAGEMENT



Source: The Cerulli Report, U.S. Alternative Investments 2018 Report with data provided by Preqin.

managers who could effectively source and vet opportunities.

Liquidity was very limited, and that limited liquidity was often an impediment to making deals broadly available.

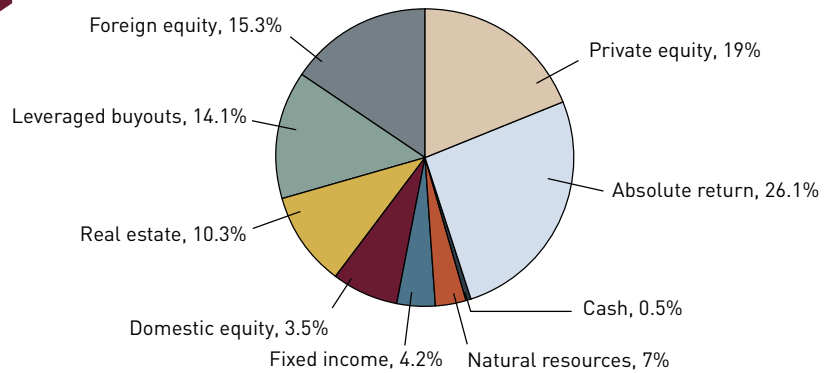
In recent years, we've seen tremendous focus on evolving the product structures to solve for investor demand (Davidow 2018). Private equity access is now available at lower minimums, with lower accreditation requirements, and tax reporting has been simplified and liquidity has improved, among other issues (see table 1).

Private funds and funds of funds were the first-generation product structure. They provide access to private equity through a limited partnership (LP) structure. They are available only to qualified purchasers (QPs)—individuals or family businesses with at least \$5 million in investments—and offer little, if any, liquidity. They provide Schedule K-1 reports, which some investors find complex, and they are subject to capital calls when the fund needs capital.

Feeder funds provide scale to the fund's general partner by aggregating underlying investors. They have become popular because investors gain access to a private equity fund at lower minimums (as low as \$150,000 to \$250,000). Investors still receive K-1s and are subject to capital calls.

Figure 6

YALE ENDOWMENT MODEL



Source: Yale Investments Office. Data as of June 30, 2018.

Interval funds represent the next evolution of private equity (SS&C 2018). They often are available at much lower minimums (\$25,000) and may be available to accredited investors (AIs) and qualified clients (QCs), who are allowed to deal in securities that may not be registered with financial authorities. Their big advantage is the ability to provide some level of liquidity (often quarterly), but the tradeoff for the better liquidity has been a pretty significant cash drag. Funds are forced to meet redemptions, therefore they will hold cash and cash equivalents.

Auction funds are the latest innovation in private equity structure (Griggs 2018). Auction funds are a unique structure developed by Nasdaq that

seeks to solve for some of the structural limitations available in the market. They are structured as a closed-end fund that is offered continuously. They are typically registered under the Investment Company Act of 1940 or as a business development company (BDC). These funds solve the cash drag of interval funds by offering an auction structure that is similar to the way an exchange-traded fund (ETF) trades. Overall, the structure can be thought of as a slow-motion ETF for private equity. Although primary liquidity is through trading instead of redemptions, it also has an embedded arbitrage mechanism similar to the one that keeps ETF prices in line with the net asset value of the underlying basket (Rice 2017).

Table 1

EVOLUTION OF PRIVATE FUND STRUCTURES

	Classic LPs/FOFs	Feeder Funds	Interval Funds	Auction Funds
Minimums	High minimums	Lower minimums (\$150K-\$250K)	Lower minimums (\$25K)	Lower minimums (\$25K)
Accreditation	Qualified purchaser only	Qualified purchaser only	Lower accreditation (QCs & AIs)	Lower accreditation (QCs & AIs)
Tax reporting	K-1 reporting	K-1 reporting	Can be tax RICs	Tax RICs, 1099 reporting
IRA eligibility	No	No	Can be	Yes
Investment	Capital call	Capital call	No capital calls	Continuously offered, no capital calls
Liquidity	Secondary sale to QPs	Secondary sale to QPs	Quarterly self-tender by fund	Market auctions, backstop tenders
Liquidity caps	Secondary: 2% max (max 10% with qualified minimums)	Secondary: 2% max (max 10% with qualified minimums)	Generally, 5% per quarter	No cap on liquidity
Cash drag	None	None	Significant	Typically none

Note: Private equity access is now available at lower minimums, with lower accreditation requirements, and tax reporting has been simplified and liquidity has improved.

Source: Tanager Capital and Schwab Center for Financial Research

Table
2

IMPACT INVESTING

	← Minimize Negative Impact		Target Impact →	
	Restriction Screening	ESG Integration	Thematic Exposure	Impact Investing
Impact Priorities	Managing exposures by intentionally avoiding investments generating revenue from objectionable activities, sectors, or geographies	Proactively considering ESG criteria alongside financial analysis to identify opportunities and risks during investment process	Focusing on themes and sectors dedicated to solving sustainability-related domestic and global challenges	Allocating to investment funds focused on private enterprises structured to deliver positive social and/or environmental impacts
Characteristics	Differentiated by restriction criteria and degree of shareholder advocacy Not proactively seeking environmental and social impact	Differentiated by ESG integration process and degree of shareholder advocacy May also include screens	Differentiated by macroanalysis, sustainability, research, and sector focus	Differentiated by impact approach, regional focus, liquidity, and impact reporting May have investor restrictions
Investment Examples	Mutual fund that excludes companies from buy universe (e.g., tobacco, firearms, coal mining companies)	Separately managed account incorporating analysis of ESG performance into stock selection process	Exchange-traded fund tracking index of renewable energy companies	A private equity fund focused on emerging consumers or project level renewable energy investment
	Public and Private Markets			Private Markets

Source: Morgan Stanley Institute for Sustainable Investing

With the innovation in product structures, investors have multiple ways of accessing private equity. They can own individual private equity funds or diversified pools. They can lock up investments for seven to 10 years, or gain greater liquidity through interval or auction funds. Private equity is now available at lower minimums for more investors.

WHAT'S NEXT?

Recently, there has been an intersection of two major industry trends: demand for private equity and interest in impact investing. What if you could do well by doing good? We've covered the demand for private equity in this article, so let's touch on the interest in impact investing (see table 2).

According to a recent survey, 63 percent of women consider social, political, or environmental impact in making investment decisions (VanderBrug 2017). The survey showed that 62 percent of women engaged in impact investing because it was "the right thing to do," and 79 percent of millennials believed one can "do good" and "do well."

Also, 90 percent of millennials said that a company's impact on society and the

environment is important, and 80 percent said they would favor companies with a positive impact over ones that are harmful. The interest in impact investing isn't isolated to just women and millennials, but these two groups stand out.

Impact investing and private equity seem like a perfect marriage (The Rockefeller Foundation 2019). Impact investing also aligns nicely with so many large foundations focusing on creating positive change. For example, the Gates Foundation is focused on curing diseases, the Bloomberg Foundation on reducing carbon footprints, and the Rockefeller Foundation on healthy food and clean water, among other issues. The point is that many wealthy families in the United States and around the globe are focused on leaving lasting legacies. Private companies are often the vehicle to effect these changes.

Another area of growth is co-investment, which is a minority investment in a company made by investors alongside a private equity fund manager or venture capital firm. For example, the Teacher Retirement System of Texas has indicated a desire to increase its

co-investment allocations from 20 percent to 30 percent or 50 percent (Cerulli Associates 2018). Co-investment opportunities range from investing on a deal-by-deal basis to co-investment funds generally offered by funds of funds. These types of funds are attractive because of the ability to invest alongside some of the best and brightest minds.

Due to the increased interest, some fund managers have offered "sidecars," which are more formalized structures designed to pool co-investment money from LPs (see figure 7). Historically, co-investment opportunities were reserved for very large institutions and family offices. This structure also is attractive to general partners, because of the increased capital that allows them to target bigger deals.

In mid-June 2019, the Securities and Exchange Commission (SEC) issued a request for public comment on its current limitations regarding access to private equity and other alternative funds for both retail and retirement investors. The SEC is considering how to "simplify, harmonize and improve this exempt offering framework to expand investment

opportunities while maintaining appropriate investor protections and promote capital formation” (Waddell 2019).

SEC Chairman Jay Clayton has expressed support for including private funds in 401(k) plans and loosening accreditation standards.

This is a potentially game-changing development, because private equity could be included in target-date funds and 401(k) plan menus. This could be a win for the individual investor who hasn’t been able to access these investments—and a boon for the private equity industry. It will be interesting to see if this comes to fruition in the coming years.

CONCLUSION

Private equity represents an attractive investment opportunity. Due to innovations in private equity product structures, these investments are now more appealing than ever and easier to access for the average high-net-worth investor. Private equity access is now available at lower minimums and with lower accreditation requirements, tax reporting has been simplified, and liquidity has improved, among other issues.

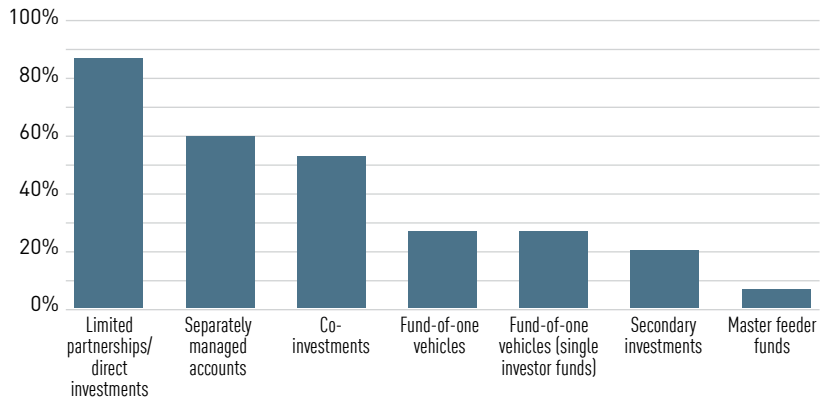
Advisors should evaluate the various structures and associated tradeoffs before investing. Although investors should consider the risks, private equity warrants closer attention in a lower-return environment, coupled with the growing number of companies remaining private longer.

This article has tried to lay out a case for private equity, and it has discussed some of the tradeoffs in the various structures. We discussed such important considerations as allocating across private equity, including diversification based on stages, manager, geography, industry, and vintage.

We discussed the J curve and cash drag often associated with investing in this asset class. With recent innovation, it is now easier for high-net-worth investors

Figure 7

PRIVATE INVESTMENT STRUCTURES MOST FREQUENTLY REQUESTED BY INVESTORS, 2018



Source: Cerulli Associates (2018)

to own diversified private equity exposure. They can minimize the impact of the J curve and spread risk across multiple investments.

Lastly, we’ve offered a glimpse into the future, with the increased focus on private equity, impact investing, and co-investing opportunities. We also discussed the SEC interest in making private equity more available to Main Street investors.

There will no doubt be other innovations and challenges in the years to come. Private equity holds the promise of identifying the next Apple, Google, or Facebook—and more. ●

Anthony B. Davidow, CIMA®, is chair of the Investments & Wealth Monitor editorial board and served on the Investments & Wealth Institute board of directors from 2009-2015. He earned a BBA in finance and investments from Bernard M. Baruch College. Contact him at anthonydavidow@gmail.com.

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