2. Private equity funds, funders and other market participants

In this section we examine the motivations and constraints of each of the major participants in the private equity market. We summarise the academic evidence to date on the activities of private equity firms and their impact on companies and wider stakeholder groups. We then go on to clarify the principles that underlie the taxation status in the UK of the various parties.

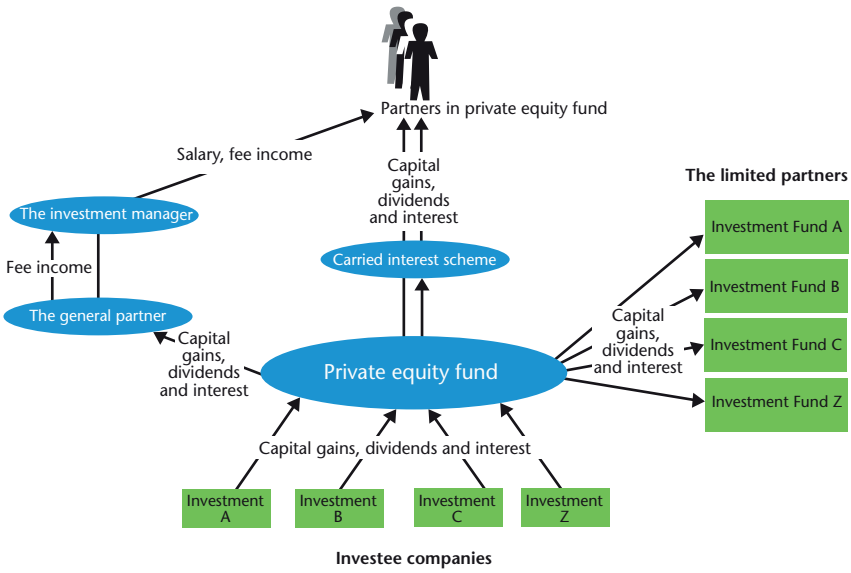
2.1 The private equity fund

2.1.1 What is a private equity fund?

As we noted in section 1, much, but not all, of the investing done in the private equity market is by private equity funds. A private equity fund is a form of 'investment club' in which the principal investors are institutional investors such as pension funds, investment funds, endowment funds, insurance companies, banks, family offices/high net worth individuals and funds-of-funds, as well as the private equity fund managers themselves.

2.1.2 How are private equity funds structured? 'Ten plus two' funds

Figure 2.1: Structure of a typical private equity fund (July 2014)



Source: Gilligan and Wright.

The fund manager manages one or more funds. These are invested in by a variety of institutions and other bodies. The funds have a limited life, meaning that there is a pre-agreed date on which they will stop making new investments and subsequently be wound up. Typically a fund invests in new projects for six years and is wound up in 10 years. There is a standard extension period of two years in most fund agreements, hence they are generally known as 'ten plus two' limited life funds. This is discussed more extensively below.

2.1.3 Why are private equity funds partnerships?

The fund manager itself may or may not be a partnership. However, each fund is usually a separate limited life partnership. There is much misrepresentation and confusion about why these structures exist. In essence the problem that needed to be solved was: how can a group of institutions and individuals create a structure that would bind them together as investors for a finite period without creating multiple tax charges?

Note that the starting point is not to avoid tax, it is to avoid duplicating tax charges. Each investor should be taxed according to their individual tax position. The problem was to avoid creating a vehicle that would also be taxed before the investors were paid out. If a limited company had been formed, for example, it would have had a corporation tax liability and would have had to be solvently liquidated at the end of the investment period. Similarly, in a traditional partnership (at that time) all the partners in any partnership jointly and severally guaranteed each other's obligations. Clearly this is not a vehicle that would be appropriate to a mutual investment fund with multiple disparate investors.

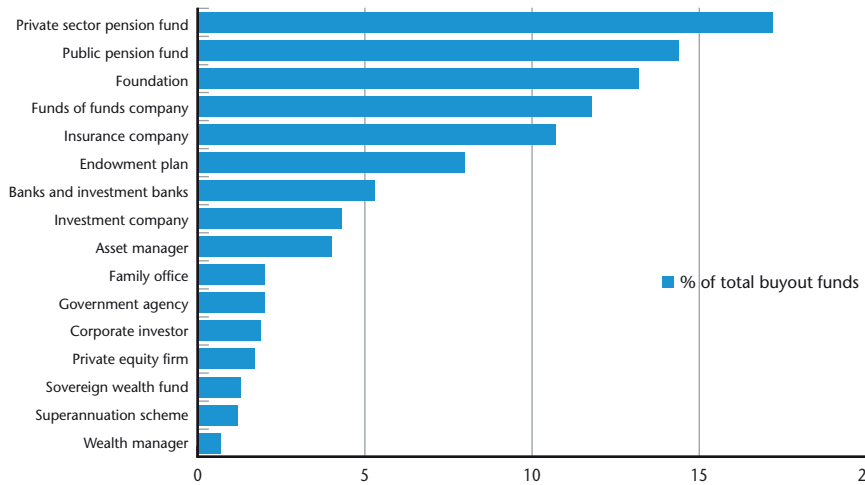
To solve these types of problems, in the UK, structures created by an obscure piece of early twentieth-century legislation were revived. These are called limited life partnerships. They allow partners to come together to cooperate for a finite period without creating a new layer of taxable income or requiring the partners to jointly and severally guarantee each other's liabilities.

2.1.4 What are LPs and GPs?

The external investors are called limited partners (LPs) because their total liability is limited to the amount they invest. The manager is often called the general partner (GP). The general partner has potentially unlimited liability for the actions of the fund. To put a cap on this potentially unlimited liability many GPs are in fact limited companies or partnerships. Technically, the fund manager invests in the general partner; however, in common usage, LPs are investors and GPs are fund managers.

2.1.5 Who are the investors in private equity funds?

Figure 2.2: Investors in private equity (2014 TD)



Source: Preqin.

Pension funds constitute the largest category of investors in private equity and venture capital funds and the largest proportion of funds raised are buy-out funds (Figure 2.2). The largest investors are the largest pension funds, which are generally public sector schemes around the world. Ultimately many of the investors are members of the wider public who contribute to pension schemes and collective saving funds and who purchase pension products.

Note that many of these investors are pension funds and charities which are typically not liable to tax. Therefore any structure that imposed a tax at the level of the investment vehicle (a limited company, for example) would be a unique tax on private equity. These investors pay no tax on investing in public shares, and some of the complex structures seen are how a similar position is reached in private equity.

Segregated data for the large buy-out funds alone are not published by the quoted sources, but are likely to be similarly distributed, though with fewer individuals and academic and government agencies investing. Buy-out funds accounted for 85% of funds (by value) raised in 2006, the top of the boom period.

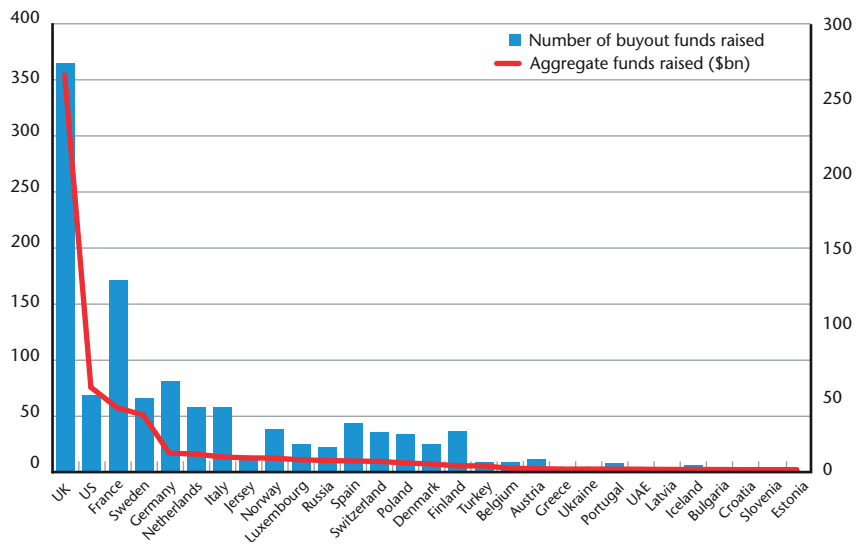
Elsewhere in this report we summarise the findings on investment performance by private equity funds. We are not aware of any research that does a similar analysis of fund-of-funds, the largest of which are shown in Table 2.1.

Table 2.1: Top 20 fund-of-funds investors in global private equity 2013

Firm name	Private equity assets under management ($bn)	Firm country
AlpInvest Partners	48.4	US
Goldman Sachs AIMS Private Equity	41	US
Ardian	36	France
HarbourVest Partners	35	US
Partners Group	30.7	Switzerland
Hamilton Lane	29.5	US
GCM Customized Fund Investment Group	28.8	US
Pantheon	27.4	UK
Pathway Capital Management	26.8	US
Altius Associates	26.3	UK
Adams Street Partners	24	US
JPMorgan Asset Management – Private Equity Group	24	US
LGT Capital Partners	20	Switzerland
Neuberger Berman	20	US
Capital Dynamics	18	Switzerland
BlackRock Private Equity Partners	16.8	US
PineBridge Investments	16.3	US
Commonfund Capital	13.5	US
Performance Equity Management	13	US
StepStone Group	11.1	US

Source: Preqin.

Figure 2.3: Geographic origin and country of management of European funds raised in 2013



Source: Preqin.

Figure 2.3 shows the private equity and venture capital fund market by country of origin of funds raised and country of the fund manager. The domination of the UK market within Europe and the significant capital inflows managed by UK fund managers are clearly illustrated.

From anecdotal information, it seems likely that this data understates the capital inflows into the European market from countries other than the US. For example, it does not show inflows from the Middle and Far East. Accurate data on the identity of the sources of funds used by private equity investors is not publicly available. As a consequence of this lack of clarity about sources of funds, it is neither possible to assess the risks of concentration of funders within a fund, nor to assess the risk of the failure of any LP to be able to fund its commitments going forward.

2.1.6 What are sovereign wealth funds?

Sovereign wealth funds have become increasingly large investors in private equity, both directly and in funds. They are investment programmes run on behalf of governments that have budget surpluses that are not used to fund government programmes as they accumulate. The largest are those associated with countries that are resource rich (eg, oil states).

2.1.7 How are private equity fund managers rewarded?

As we discussed in section 1, in addition to a salary and the returns as an investor, GPs receive two other income sources.

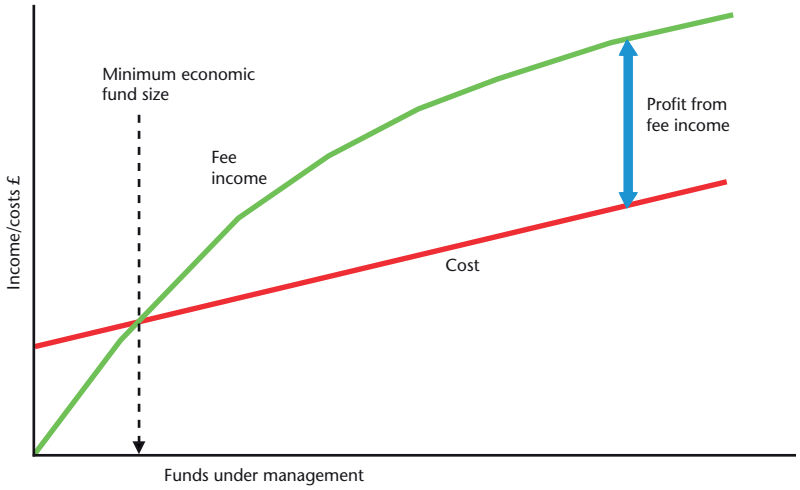
Fee income

Fund managers (GPs) receive management fees that are expressed as a percentage of the funds raised. The larger the fund, the greater the fee income, although the percentage generally declines from around 2%–3% in smaller funds to 1%–1.5% in larger funds. The management fee was originally intended to pay for the operating costs of employing staff and other expenses associated with the fund manager's business, plus the reasonable salaries of the partners. Any excess over these costs is retained by the management company (the manager) and may be paid to its partners/shareholders. Fund managers have to balance the use of fee income to reinvest in growing the personnel, infrastructure and assets of the business with the requirement to recruit and retain their best partners by offering industry-competitive remuneration.

It has been argued that the growth in fund size has resulted in the creation of a new principal–agent problem within private equity funds. As illustrated in Figure 2.4, the larger funds generate fees that may result in substantial profits to their partners. These profits accrue whether or not the fund itself is successful. This challenges the central idea of alignment of interest driving value creation. Partners are receiving a risk free return if they can raise a large fund. The evidence regarding historic sustained outperformance by the best funds has prevented new entrants from competing away the profit from fee income.

As fund performance has been impacted by the economic downturn, the balance of power between LPs and GPs (investors and managers) has begun to alter. There is much discussion within the LP community regarding fee levels. Some argue that publicising fees would result in economic efficiencies.

Figure 2.4: The relationship between costs and income

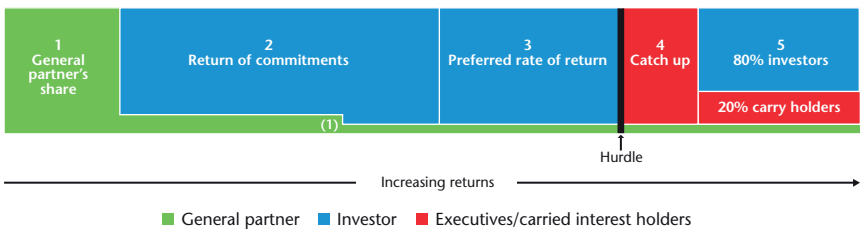


Source: Preqin.

Carried interest

The second source of reward for private equity fund managers is a share in the profits of the fund; this is generally known as carried interest (or carry). Once the investors have achieved the hurdle rate, the fund managers will share in the excess and usually this was 20% of any excess. The hurdle rate (historically around 8% per annum but variable from fund to fund) is calculated on the amounts actually invested.

Figure 2.5: The mechanics of carried interest



Source: Adam Frais/ BDO (UK) LLP.

The mechanics of the calculation are intricate (Figure 2.5). Over the life of the fund, net income and capital distributions will be made in the following order.

1. The GP receives a priority share of partnership returns each year.
2. The investors then receive a 100% return of commitments advanced and a preferred rate of return (8%).
3. The carried interest holders receive 100% of all distributions until such time that they have received 25% of the investors' preferred return (2 above). This is referred to as 'catch up'.
4. Thereafter the remaining distributions are split as follows:

   (a) 80% investors

   (b) 20% carried interest holders.

Theoretically the fund could go 'into carry' if all called commitments and the hurdle rate has been paid and then go 'out of carry' if a further draw down is made.

As the market has matured there has been a constant refinement of industry practice to attempt to ensure that the carried interest calculation tightly aligns the interests of investors and fund managers. However, in a long-term, illiquid investment business with low levels of transparency to new entrants, this process of realigning interests may take longer than in other industries. Management fees can be structured as an advance of carried interest but are nevertheless payable to the manager even if the fund generates no profits and no carried interest.

These funds are known as 'two-twenty' funds: ie, 2% fee and 20% carried interest. The origin of the 2/20 (fee/carried interest) fund model has been the source of some academic investigation. It seems to be no more than a 'sticky' industry norm. Its resilience is underlined by the fact that it appears to stem from medieval Venetian trading contracts between ship owners and merchants.

2.1.8 Other fees

In addition to these fees and profit share that are common to most funds, other fees may be receivable by the fund managers.

Monitoring and/or non-executive director fees are widely payable by individual investee companies to defray some of the costs of employees and partners of private equity managers monitoring the investment. These fees may be payable to the private equity fund or to the manager, or more likely are split between them in a predetermined proportion.

Transaction costs incurred by the private equity fund in making an investment are usually payable by the new company established to effect the buy-out (Newco) and not by the private equity fund. Abort costs of transactions which fail to complete may be borne by the fund or the manager or more likely shared in a pre-agreed ratio.

Private equity fund managers may charge an arrangement fee to the investee company expressed as a proportion of the amount of money invested in a deal. These may be up to 3% of the equity invested. Usually these fees are credited to the fund but they may be split on a pre-agreed basis with the manager.

Typically, but not always, the net of all these fees would be included in the calculation of the management fee and would not increase the overall rewards of the private equity fund managers.

All of these individually negotiated arrangements within a fund manager's business impact the individual returns of investors over the long term.

Moreover, the economic impact of the array of fees charged is unclear. If a Newco borrows from its lenders to pay fees to its lenders, what profit has been made and when? The allocation and levying of transaction fees gives rise to further potential principal–agent issues between LPs and GPs.

LPs and management need to be aware of the impact of the proliferation of fees to funders on both returns and, importantly, incentives.

2.1.9 What is co-investment and how does it differ from carried interest?

In some arrangements, managers (and sometimes other founder investors) are permitted to invest directly in each individual investment as well as, or instead of, in the whole fund. This practice is called co-investment. For fund managers this is increasingly uncommon as it can create misalignment between the fund investors and the fund managers where the gains in one investment are disproportionate to the value of the overall portfolio. However, co-investment has re-emerged in a new guise in the form of 'managed account arrangements' (see below).

The objective of all of these structures is to align the interests of all parties and to incentivise and reward performance above a threshold level.

2.1.10 What are separate managed account arrangements?

Investors who have significant amounts of capital and wish to negotiate bespoke terms are increasingly turning to separate managed account arrangements. These are partnerships that mimic the main fund vehicle but have only the fund manager and the investor as partners within them. They may, sometimes at the discretion of the investor as well as the fund manager, co-invest alongside other funds managed by the fund manager. There are also co-invest arrangements with some investors that allow them to invest directly alongside the fund on a case-by-case basis.

These are dilutions to the traditional long-term commitment to a fund with discretion purely in the fund managers' hands. They have grown in popularity in both direct private equity funds and in fund-of-funds.

2.1.11 How does a private equity fund differ from a quoted equity fund?

Funds that invest in public companies operate using different business models (Table 2.2). Some quoted funds are specifically designed as income funds that seek to pay to investors a running yield generated from dividend income from shares and interest on bonds. As noted above, private equity funds do not generally aim to generate yield. They are comparable to capital growth quoted funds that seek to generate the majority of their return from increased value in their investments. Key differences between the funds are set out in Table 2.2.

Table 2.2: Key differences between private equity and quoted equity funds

Private equity funds	Quoted equity funds
Control and influence	
Private equity funds usually own a substantial or controlling stake in the business. Individual private equity investments are controlled using a detailed legally binding shareholder's agreement that establishes the contractual rights and obligations of the company, its management and the investors.	Funds investing in quoted companies usually acquire small minority stakes, which offer no control and no special rights. Institutional shareholders may be influential, but usually have no contractual control over day-to-day management decisions or strategy.
Financial structure of individual investments	
Private equity transactions are financed using a combination of the private equity fund's own capital, and third-party debt provided on a deal-by-deal basis; thus there is usually a degree of debt within a private equity fund's individual investments. The financing structure of a private equity investment usually requires the business managers to personally invest in the company they manage. They share the risks and rewards of the business.	Funds that invest in quoted shares do not increase the borrowings of the company that they invest in. They may have borrowings within their fund structure, but they do not introduce debt to the company as part of their investments. The rewards for management in quoted companies are a matter for the remuneration committee, not the shareholders. Managers are not generally required to buy shares in their company although they may benefit from capital growth through option schemes.
Information prior to investment	
Private equity funds will undertake substantial financial, commercial and legal due diligence prior to making an investment.	Quoted company funds have access to and rely on only publicly available information on the companies they invest in.

Table 2.2: Key differences between private equity and quoted equity funds (continued)

Private equity funds	Quoted equity funds
Information and monitoring while invested	
Private equity fund managers receive wide-ranging commercially sensitive information including detailed monthly management information and board minutes from each company the fund is invested in, and also often have board representation. Investors in private equity funds receive regular detailed information and commentary on each of the private equity fund's investments from the fund managers, including opinions on future prospects. The guidance for this communication is summarised in the International Private Equity and Venture Capital Investor Reporting Guidelines.	Quoted fund managers predominantly rely on company announcements, management presentations and analysts' research to monitor their investments. Investors in quoted funds receive no detailed information on the operations or management of the individual investments.
Liquidity in underlying investments	
Private equity investments are illiquid: private equity funds cannot generally sell a portion of their investments and therefore rely on a sale of the whole company to achieve a capital gain (but see later sections on secondary transactions).	Quoted shares are freely tradable, albeit in small 'parcels', on whatever stock exchange they are quoted. Quoted funds can therefore readily vary the proportion of their investment in any company by trading up or down.
Rewards to fund managers	
Private equity fund managers receive management fees from each fund they manage. They also invest directly in the funds they manage and further share in any aggregate realised profits of the fund over its whole life through 'carried interest'. As carried interest can take many years to build up and be paid, it has been argued that private equity fund managers are in effect tied into their funds for a longer period than equivalent quoted fund managers.	Quoted fund investment managers receive fee income from the funds they manage and are often rewarded for the quarterly increase in the value (realised and unrealised) of the portfolio they manage.
Rewards to the managers of the company acquired/invested in	
Management are incentivised primarily to achieve a capital gain. They invest in the financial instrument with the highest risk/reward profile in the capital structure. The private equity investor negotiates the senior managers' employment terms directly with the managers.	Managers are incentivised to achieve whatever their employment contracts reward and whatever the board agrees. In many cases this is not explicit, but may be a combination of increasing the share price, increasing profits or growing the scale of the business. Public shareholders have little direct control of employment terms which are usually agreed at a remuneration committee of non-executive directors.

Table 2.2: Key differences between private equity and quoted equity funds (continued)

Private equity funds	Quoted equity funds
Fund structure and fund liquidity	
Generally, private equity funds have a limited life of 10 years. Investors in private equity funds make commitments to invest in the fund and pay in their capital when required to do so to fund investments recommended by the private equity fund managers. When realisations occur, the fund will repay capital to investors. An investor cannot withdraw their investment and future commitment from a fund. If they wish to change their commitment they require the private equity fund manager's approval of an alternate investor. There cannot therefore be a 'run' on a private equity fund. Earnings are distributed not retained. Private equity funds do not have leverage within the fund.	A quoted equity fund has permanent capital in the form of share capital or units in a unit trust, and investors in such a fund commit all their investment to the fund when they invest but can sell their shares or units when they choose to. Funds are provided by new investors and retained earnings. Some also use borrowings at the fund level to increase returns.

Source: Gilligan & Wright.

In essence, private equity fund managers seek to control the businesses they invest in and to choose an optimum capital structure for each of their investee companies. Thus, private equity funds operate with much better information and stronger controls and influence over management than funds holding quoted equities. To achieve this they forgo liquidity in the individual investments.

A very important differentiating factor is the 10-year fixed-term fund structure. This structure is a key determinant of the behaviours of the industry. Unlike permanent funds, limited life funds do not generally reinvest proceeds received from investments. They distribute proceeds to their investors. These investors then may, or may not, choose to reinvest the money in a subsequent fund. It is this long-term commitment to the fund, coupled with the way funds are distributed that has been the defining feature of private equity investment to date.

2.1.12 How does a private equity fund differ from a group of companies?

Private equity funds and trading groups of companies are compared and contrasted in Table 2.3.

Table 2.3: Key differences between private equity and trading groups of companies

Private equity funds	Trading groups
Control and infuence	
In principle, similar.	
Financial structure of individual investments	
Borrowings are ring-fenced within each investment without recourse to the private equity fund. Profits and losses in each investment are taxed separately from other investments and therefore interest cannot be offset against profits in other investments.	Any borrowings are often cross-guaranteed by all companies in a trading group. Profits and losses within a group can be offset against each other. This allows interest to be offset against profits in a group wherever profits occur.

Table 2.3: Key differences between private equity and trading groups of companies (continued)

Private equity funds	Trading groups
Information prior to investment	
In principle similar, but private equity firms, as professional acquirers often with less sector knowledge, use more external advisers than a corporate acquirer during due diligence.	
Information and monitoring while invested	
In principle similar, although private equity firms are known for their tight monitoring of cash flow and performance against budget.	
Rewards to the managers of the company acquired/invested in	
Management are shareholders and are incentivised primarily to achieve a capital gain. They invest in the financial instrument with the highest risk/reward profile in the capital structure. The private equity investor negotiates terms of employment directly with the senior management.	Managers are employees whose rewards are a function of their employment contracts and parent company policy. In a quoted group, managers are likely to own shares possibly through a share option scheme or other share incentive scheme.
Liquidity in underlying investments	
Similar: both must sell/float an investment to realise value although value created may be reflected in the share price of the holding company in a quoted group of companies.	
Rewards to fund managers/corporate managers	
Fund managers share in the net performance of the investment portfolio over the life of the fund and are incentivised to realise capital gains.	Parent company management are incentivised as managers, not investors. There is no explicit assumption that companies are bought with a view to a subsequent sale to realise a capital gain.
Fund structure and fund liquidity	
Usually private equity funds have a limited life of 10 years. Investors cannot generally withdraw their investment and future commitment from a fund. If they do wish to do so, they require the private equity fund manager's approval of an alternate investor. There cannot therefore be a 'run' on a private equity fund. Earnings are distributed not retained. Private equity funds do not have leverage within the fund.	If quoted, the shareholders (and option holders when options are exercised) can sell their shares in 'parcels' in the market. The organisation will fund itself by a mix of debt, equity and retained earnings.

Source: Gilligan & Wright.

A group structure therefore, shares a number of the features of a private equity fund. In particular the information asymmetries seen between private equity funds and quoted funds do not generally exist. However, there are significant differences including tax advantages for corporate entities (for example with respect to the ability to offset losses in one subsidiary against profits in others) that are not available to investment partnerships. The key differences are in the incentives that private equity funds provide. Private equity funds and managers of investee companies are tightly aligned to generate capital gains on a sale/flotation of each individual investment, whereas trading groups may have to seek a wider range of goals that are articulated by the trading strategy of the overall group, rather than the individual company within the group. Managers in corporations are rewarded typically annually with a relatively small proportion tied to medium/long-term realised value growth.

The differences in the risks of the traditional private equity fund model when compared to a highly geared corporate acquirer were seen in the rapidity of the failure of Baugur. Baugur was an acquisitive Icelandic corporate that acquired a number of UK companies with a particular focus on retailers. Baugur used debt within each of its investments and further debt within its own balance sheet to generate high levels of risk and potential reward. Furthermore it was a major shareholder in a number of its lending banks. Following the collapse of the Icelandic banks, Baugur was declared bankrupt on Friday, 13 March 2009. It failed due to the use of excessive levels of debt in each layer of its business creating systemic risk. Private equity structures explicitly eliminate this type of risk.

2.1.13 What are hedge funds and how do they differ from private equity funds?

Hedge funds emerged to invest in shares and in derivative assets used by corporations to hedge their risks. The original hedge fund investment proposition is that the fund manager can make a superior return by making a series of trades in these derivatives and the underlying assets. The original hedge funds often sought arbitrage opportunities arising from the misalignment in the price of derivatives and/or the assets underlying the derivatives.

In order to generate these returns the hedge fund manager will use both financial leverage, in the form of borrowings in the fund itself, and leveraged trading positions (derivatives). This generates increased risk, matched by increased returns when successful.

As markets become more globally integrated and liquid, the returns earned from pure arbitrage by hedge funds have diminished. These funds therefore have sought to widen their trading strategies to achieve returns and some have turned to investing in private equity transactions as debt and/or equity providers.

Table 2.4: Key differences between private equity and hedge funds

Private equity funds	Hedge funds
Investment strategy	
Private equity funds are skilled in using transactions and active management to generate profits outside the quoted markets.	Traditionally hedge funds make returns from a series of related trading positions, rather than single investment decisions. They are generally skilled in using markets and market inefficiencies to generate profits.
Control and influence	
Private equity funds usually own a substantial or controlling stake in the business. Individual private equity investments are controlled using a detailed legally binding shareholder's agreement that establishes the contractual rights and obligations of the company, its management and the investors.	Hedge funds generally invest in quoted companies and may acquire large minority stakes, which offer no control and no special rights, but may have some influence over the company's board. Trading strategies differ: some are 'active funds' that seek to change management or strategy; some are pure trading funds seeking to benefit from market price movements.
Financial structure of individual investments	
Private equity investments have borrowings within the investee, but generally no borrowings in the private equity fund.	Hedge funds may create financial risk and reward by using derivatives (options, swaps etc) rather than debt. It is common for larger hedge funds to have borrowings within the fund, using financial leverage to increase risks and rewards.

Table 2.4: Key differences between private equity and hedge funds (continued)

Private equity funds	Hedge funds
Information prior to investment	
Private equity funds will undertake substantial financial, commercial and legal due diligence prior to making an investment. In a management buy-out, the knowledge of the incumbent management is extremely valuable in assessing risk and reward.	Investors in quoted assets, such as many hedge funds, have access to and rely only on publicly available information on the companies they invest in. However, hedge funds use similar due diligence methods to private equity funds when investing in unquoted assets.
Information and monitoring while invested	
Private equity fund managers receive wide-ranging commercially sensitive information including detailed monthly management information and board minutes from each company the fund is invested in, and also often have board representation.	Where assets are quoted, hedge funds rely on public information to monitor their investments. The active funds' investment thesis is that they will use their stake to positively influence the direction of the businesses in which they invest. Pure trading hedge funds may simply take a 'position' in a company in the anticipation that the company's value will change to their benefit.
Liquidity in underlying investments	
Private equity investments are illiquid: private equity funds cannot generally sell a portion of their investments, they rely on a sale of the whole company to achieve a capital gain.	Quoted assets are freely tradable, albeit in small 'parcels', on whatever stock exchange they are quoted. Large stakes are less easy to place (sell) than smaller ones. Therefore, broadly, the greater the influence sought, the less liquidity is available.
Rewards to fund managers	
Private equity fund managers invest in the fund they manage and share in any aggregate realised profits of the fund over its whole life through 'carried interest'. As carried interest can take many years to build up and be paid, it has been argued that private equity fund managers are in effect tied into their funds for a longer period than equivalent quoted fund managers. Fee income is also paid by each fund.	Hedge fund managers are often rewarded for the quarterly increase in the value (realised and unrealised) of the portfolio they manage. In addition they receive fee income from the funds. There is not usually a hurdle rate of return to exceed.
Fund structure and fund liquidity	
Private equity funds are usually long-term illiquid commitments for a finite period and they cannot suffer a 'run' on the fund. There is rarely any borrowing within the fund and therefore there is generally no bankruptcy risk. Private equity funds usually have a defined narrow investment focus, although this is becoming broader and less defined in successful funds.	Hedge funds are open-ended investment commitments that allow their investors to sell their units of investment (subject to various lock-up clauses), either in a public market or a periodic private market. They also often have borrowings within the fund. They therefore carry a risk of bankruptcy and can have a 'run' on the fund. Hedge funds can and do fail. Hedge funds often combine wide-ranging investment strategies seeking superior returns.

Source: Gilligan & Wright.

Hedge funds, in their private equity activities, therefore generally sit between the private equity fund model based on low liquidity, financial engineering, high control and information and the quoted fund model based upon a trading strategy in highly liquid stocks.

The key difference is that private equity funds are long-term commitments by the investors and have not historically used debt within the fund structure itself to generate returns.

It is possible that hedge funds may emerge with different mandates and a focus on private equity investments, in which case such funds may create market risks that do not currently exist in the private equity market, for example:

- hedge funds, which themselves are often leveraged, investing in investments using debt, would increase gearing and thus compound the risks associated with leverage; and
- funds that offer investor liquidity investing in illiquid investments create a mismatch of assets with liabilities. Since this observation was made in the first edition of this publication a large number of hedge funds have indeed failed, or been required to restructure due to the liquidity provided to their investors.

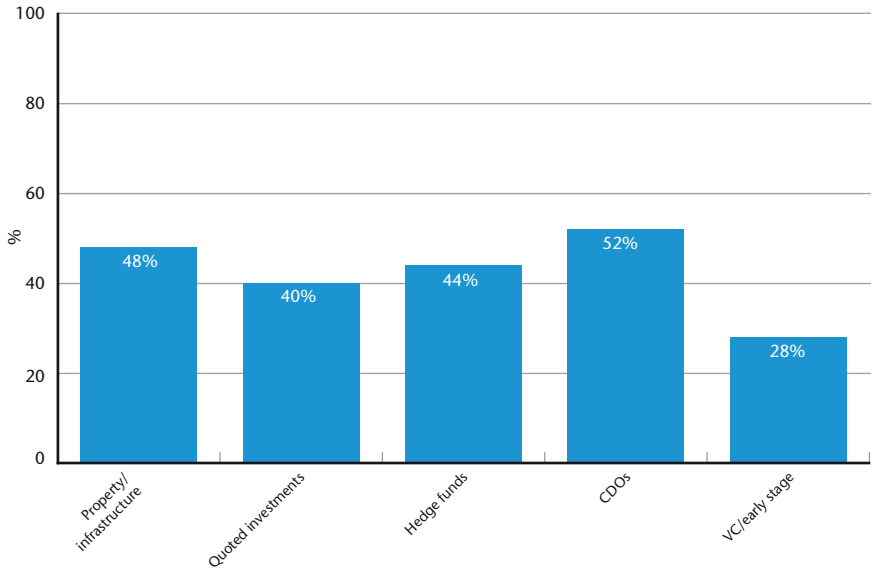
The term 'hedge fund' does not have a precise definition and covers a wide variety of fund models, which makes drawing general differences difficult. We have tried above to characterise fairly the key differences in the general business model and structures utilised. In reality there is overlap between the various fund types at the margins: some private equity funds invest in alternative assets and quoted assets, and some hedge funds have long-term capital commitments. However, the general principles of fund management remain that the fund must match the term of its assets and liabilities and that competitive pressure can lead institutions to a mismatch that only becomes apparent when liquidity tightens.

2.1.14 Emerging and converging alternative asset investors

The analysis above draws distinctions between different types of fund structures. As funds have grown in size, a number of the largest private equity fund managers have diversified into areas outside the traditional private equity model. Similarly investors in hedge funds, investment banks and other institutions have moved into private equity investing. Essentially we have seen the emergence of 'alternative asset' fund managers and advisers.

Figure 2.6 shows a high-level analysis of the 25 largest private equity funds in the world and their wider portfolio management activities. Few are involved in the early-stage venture capital market. A significant minority (44%) of the managers own hedge funds. Over 50% have fund management teams that operate collateralised debt obligations (CDOs). Only a minority of these largest fund managers are focused purely on private equity investment. Noticeably this focus on pure private equity is seen to a much greater extent in UK-based funds than their US counterparts. This may reflect the relative maturity of the UK versus the US private equity market.

Figure 2.6: Forms of diversification undertaken by world's largest private equity managers



Source: Gilligan and Wright.

We suggest that an examination of the hedge fund industry may similarly find that the largest hedge funds have started to become active in the private equity market whether as equity investors or as providers of debt and mezzanine to support buy-outs.

It is clear that the boundaries of the various alternative investors are blurring. One possibility is that private equity will respond to this competitive threat by taking on greater risks either in pricing and structuring investments or by changing the underlying long-term commitment model and introducing leverage into the fund structures. If such a trend were to emerge, our conclusion regarding the absence of systematic risk in private equity would need to be reviewed.

2.1.15 Can a private equity fund or a private equity manager fail?

As explained in section 1, private equity funds are not usually structured using third-party debt and therefore do not generally carry a significant bankruptcy risk. As noted earlier, a private equity fund may lose all the investors' capital, but, unless they create liabilities by mismanagement (eg, guaranteeing obligations of investee companies), they are unlikely to become formally insolvent. However, while the absolute risk of bankruptcy is remote, it is clear that some funds perform badly and investors do lose some or all of their committed capital.

An unusual circumstance arose in the case of UK investor Candover. Established in the 1980s, Candover grew to become one of the world's large private equity funds. It had a slightly unusual structure that led to its demise. Its general partner (also confusingly named Candover) was itself a quoted company on the London Stock Exchange. In the financial crisis it became clear that the quoted general partner (which had debt within it) could not be certain of being able to finance its commitments to the latest Candover fund. In consequence the other investing LPs were able to renegotiate a cancellation of the fund commitments, leaving Candover without a new fund to invest from. This arose because it was the general partner which could not commit to the fund rather than any of the limited partners.

In the case of Permira, its founder investor, SVG Capital, also a quoted company, found itself with similar capital constraints. However, because SVG is an LP in Permira, not the GP like Candover, the renegotiation that ensued simply scaled back the size of the fund.

As we have emphasised above, it is important to understand that the failure of a fund does not mean that its investments will also fail, unlike in most corporate structures. There is no guarantee from the investments to the fund. There may be adverse impacts due to a lack of follow-on funding for example, but the private equity fund structure acts to contain, not disseminate, risk.

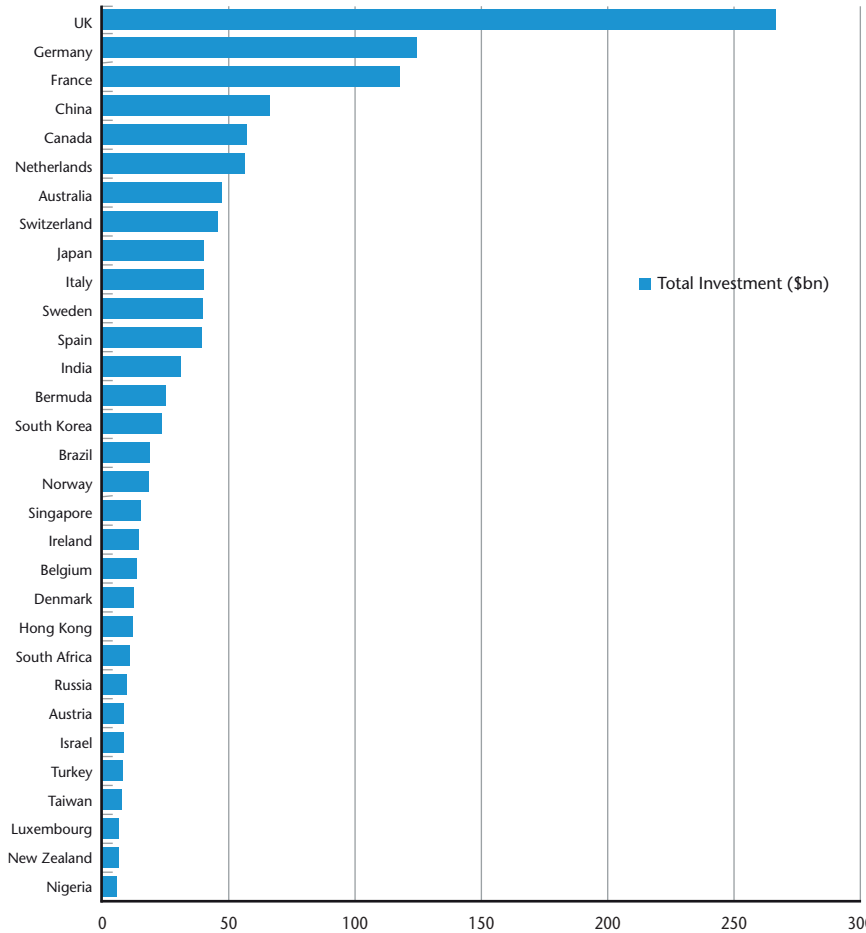
In extremis the investment agreement usually has a 'divorce clause' that allows investors to terminate the agreement if (typically) 75% by value of the committed investors agree to do so.

There is virtually no evidence or research in academic studies regarding the failure rates of private equity fund managers, in part due to the rarity of its occurrence.

2.1.16 Where do private equity fund managers operate?

Since the mid-1980s many of the larger private equity fund managers have opened overseas offices in order to source deals internationally. In the 1990s, US private equity funds began to establish European offices, predominantly in London. Today the largest private equity funds operate in a market funded by international investors as private equity markets have developed worldwide. The UK private equity market is the second largest in the world after the US (Figure 2.7).

Figure 2.7: Investment $bn by country January 2006–July 2014 (exc. US; countries with at least $5bn invested)



Source: Preqin.

2.1.17 Why have European private equity funds been based predominantly in the UK?

Private equity fund managers require four necessary conditions to operate:

- availability of funds to invest;
- opportunities to make investments ('deal flow');
- people with the necessary skills to source, negotiate, structure and manage investments; and
- the availability of exit opportunities (stock market, M&A market).

Each of these necessary conditions is met in the UK. However, the number of alternative locations worldwide where they are also met is increasing due to the globalisation of both financial markets and professional service firms. The choice of the UK is therefore increasingly dependent on a complex interrelation of other economic, legal and cultural factors, including:

- **Economic environment:** local costs and benefits and the overall economic infrastructure of the location are very important. Private equity funds are heavily

reliant on third-party advisers both for the provision of services (legal, accounting, corporate finance etc) and for deal flow. Similarly, the reliance on leverage requires a banking infrastructure able to provide efficient support for leveraged acquisitions. There is an increasingly symbiotic relationship between the private equity industry and the various providers of professional services and leveraged capital. The latter are heavily dependent on transaction-driven fees, the former are reliant on external technical advice and sources of deals. Similarly, the availability of exit opportunities in a location is a further factor favouring the UK. The London stock markets provide both deal flow and exit opportunities.

- **Regulatory environment:** at the margin, regulatory risk impacts both the availability of funds and the cost of funds. This in turn flows directly to managers' personal rewards. The UK's regulatory environment imposes costs, but nevertheless confers benefits, on fund managers that are generally regarded as being at best favourable, or at worst, not unacceptable. There has been growing national and international pressure to increase the regulation of private equity in eg, the EU, US etc. The impact of this on the London market is as yet unclear.
- **Taxation environment:** the objective of any fund manager is to maximise the returns to its investors. The funds are structured to attempt to manage the tax burden from the investee company to the ultimate fund investors in such a way as to avoid double taxation and legitimately to minimise the overall tax burden. In principle this is no different from any other investment business.
- **Legal environment:** the efficient enforcement of contract law is important where there are potential default risks and the stated objective is to sell or float the investment in a given period. There are also particular legal structures such as the limited partnership available in the UK (and indeed in other jurisdictions) which allow for the management of liabilities without causing double taxation.
- **Cultural environment:** private equity funds are becoming increasingly multicultural as they expand their activities internationally outside Anglo-Saxon economies. They are, however, by ancestry an Anglo-Saxon phenomenon, and while this may be less important in the future due to the changing mix of new recruits, they are still largely run by senior partners from the UK and North America. A degree of institutional inertia may therefore favour location in the UK in the short/medium term.

In summary, the necessary infrastructure and services to support private equity are found in the UK, together with a strong capital market. As the industry has developed, the UK has continued to have a wide range of competitive advantages over other potential locations. However, the scale of the industry and its increasing international outlook may weaken the cultural and historical ties to the UK.

It is important to note that being located in the UK does not preclude any business from having significant offshore activities.

2.1.18 Fund raising and investors in private equity funds

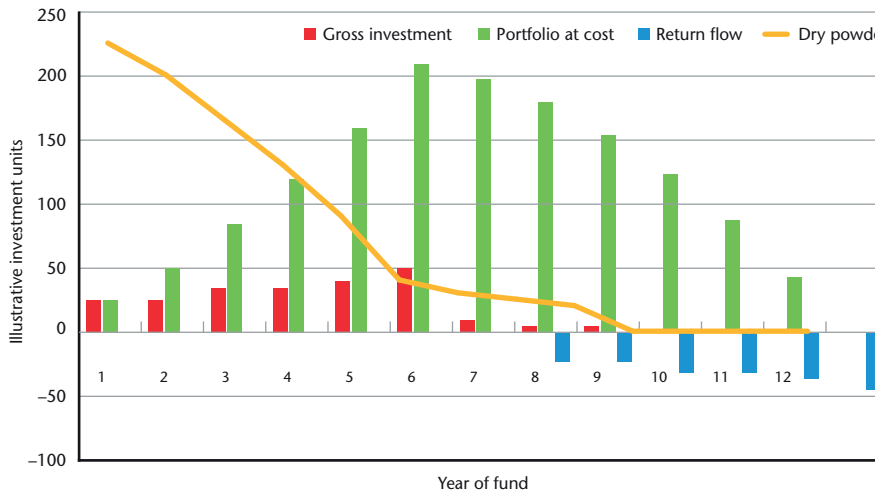
It is of course a necessary condition of being a private equity investor to have funds to invest. In section 1 we described the move away from captive funds and the emergence of the current 'standard model': the 'ten plus two' year limited life fund. Usually these funds make investments for around six years then the fund moves into a period where no new investments are made other than further capital committed to existing companies.

2.1.19 Committed versus invested capital

It is important to understand that private equity funds do not generally drawdown funds until they are needed. An investor makes a commitment to invest in the opportunities a fund manager selects for the fund. They do not deposit the cash with the fund manager. The GP fund manager has certainty of funds, but for the LP investor in the fund this means that they have an uncertain cash commitment to any particular fund, both in terms of timing of drawdown and the total amount that will be drawn down.

This makes private equity funds particularly difficult to forecast from a cash perspective. The GP fund manager protects themselves from the risk of an LP being unable to fund their commitments by putting in place a mechanism whereby if an LP funder cannot invest the other LPs take up their investment. The LP that fails to fulfil their commitment then substantially loses their rights and returns under the investment agreement.

Figure 2.8: Private equity investment cycle



Source: Gilligan and Wright.

Figure 2.8 shows an illustrative life cycle of a fund (at cost). In the early years there are large undrawn commitments (so-called 'dry powder'). As cash is invested (gross investment) dry powder diminishes and the portfolio (at cost) is built. As loans are repaid and realisations made ('return flow') the cash flows reverse for the investors typically from around the end of year six or seven.

The graph above illustrates a typical investment cycle and the planned return flow from the portfolio (excluding realisations and refinancings). As investments are geared, there is a redeemable element that is repayable, usually in years 5, 6, 7, 8 depending on the particular deal terms.

Gross investment: gross investment is the cash invested in each company. It can be a first investment into a company new to the portfolio, or a further investment into an existing portfolio company. Traditionally a fund could make first investments up to the end of year 6 and thereafter it could only make supporting further investments in companies already in the portfolio. Therefore, in order to be able to make ongoing new investments a private equity fund manager had to raise new funds before the end of the existing fund's five-six-year investment window.

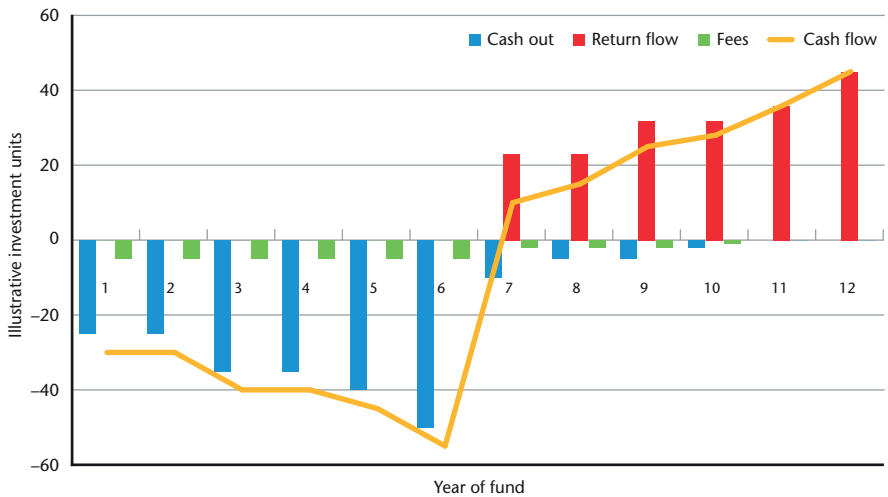
No recycling of capital: return flow is the name given to cash receipts from the underlying investments. These consist of income in the form of interest, dividends and (sometimes) fees, plus any capital repaid, from for example loans made as part of an investment. In addition any capital gains will be received as they are realised. A second key feature of most private equity funds is that they do not generally recycle capital. Repayments are paid back to the investors as they are received, not reused by the fund. Therefore a fund is limited to gross investment up to its committed capital, but not beyond, irrespective of how much cash is returned through return flow and capital gains. Private equity investors are not 'flush with cash' after a realisation, it all goes back to the investors.

2.1.20 Investor cash flows: the J curve (at cost)

As a result of the investment and realisation profile of any fund, an investor will generally see a highly uncertain pattern of cash flows, but one that will tend to have net cash out in the early years and net cash in later years.

In practice private equity is characterised by very lumpy cash flows, in terms of both new investments and realisations. The stylised example below does not assume any early realisations from successful investments (Figure 2.9).

Figure 2.9: Illustrative investor cash flows



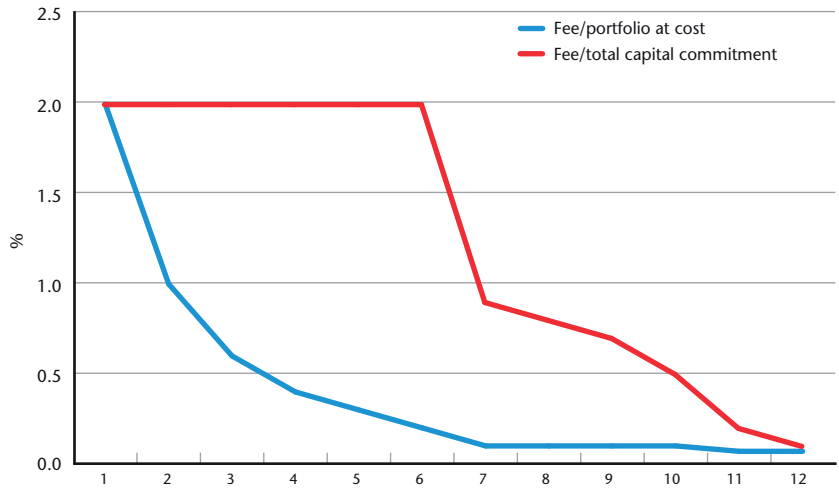
Source: Gilligan and Wright.

When private equity funds represented relatively small commitments by very large institutions, the fact that the LP investors had volatile cash flows was comparatively unimportant. In the scheme of a large institutional investor these volatilities were not a material management problem. As fund sizes and the number of funds grew, these volatilities started to present significant cash flow management issues to some investors, in particular those with borrowings predicated on cash flows from existing investments and those with high levels of commitment relative to their overall business. This is one of the factors that has encouraged the emergence of the secondaries market as discussed below.

2.1.21 Fund management fees

The fund investors pay a management fee based on the amount of capital committed up to the end of the investment period (Figure 2.10). Once the investment period ends, the fee typically reduces to a percentage of the capital actually invested, rather than the total committed. If the fund is extended beyond 10 years the fee arrangements will again fall.

Figure 2.10: Illustrative fund management fees over time



Source: Gilligan and Wright.

As noted above, fees were historically 2% of the capital committed or invested. Fees have come under sustained pressure, especially in larger funds and multiple fund managers where the quantum of fee income was argued to have created serious misalignment between the investors and the managers who received the fees.

Much as the pension management fees charged have come under scrutiny, so those charged by private equity fund managers have also come under scrutiny.

2.1.22 Fund extensions

If by the tenth anniversary of closing the fund the investments have not been realised the manager can seek a fund extension. Seeking an extension has generally been seen as a sign of poor performance; however, situations have arisen where holding a portfolio of investments for longer has been the desired outcome and 'positive' extensions have occurred.

An extension of the investment period earlier in a fund's life is typically a sign that the manager has not been able to deploy the capital commitments as planned. This has been common in the funds raised in the period immediately prior to the crash. In a number of these cases the LP investors have taken the opportunity to amend the terms of the original agreement by reducing fees and promoting tighter alignment of objectives.

2.1.23 Competition for funds by private equity managers

When funds are being raised, investors are offered the opportunity to commit an amount of capital to the fund. As the fund has no underlying assets, other than the goodwill of the manager, there is no pricing mechanism in the cost of fund units to ration demand. There is, however, generally a minimum amount which can be committed. If a fund is oversubscribed, by agreement with LPs, the private equity fund managers may enlarge the fund, or may scale back investors' applications.

The demand for investing in a particular fund will, to a large extent, depend on the investment track record of the private equity fund managers. However, an investment decision by an LP will also be influenced by the way it is proposed to share investment returns between the LPs and the manager. There is, therefore, competition between funds based upon the management fees charged, the hurdle rate of return, and the priority of the returns between LPs and the GP and the carry percentage.

2.1.24 What are founders' rights and re-ups?

New funds often offer investors preferential founder investor rights to invest in subsequent funds. These may also include preferential rights to share in carried interest. These preferential rights fall away if an investor does not support a particular fund raising. Investors who are invested in predecessor funds who invest in subsequent funds are said to have 're-upped' their investment.

Volume discounts for the largest investors are also increasingly common, with some funds offering a stepped series of terms dependant on the amount invested.

2.1.25 What is 'most favoured nation' status?

In order to protect themselves from having rights that are less favourable than other investors, some LPs seek a status akin to that of 'most favoured nation' in trade. This states that if any investor has rights that are more favourable than those negotiated, those rights will automatically be given to the investors holding most favoured status. This is intended to ensure that the investor gets the best deal that they can. In practice fund managers have turned it on its head and used it to block individual negotiations about the terms of the LPs investment. The position adopted is 'I'd like to negotiate, but my other investors have most favoured nation status so I just cannot afford to', or some similar position. It has therefore, ironically, become a block on individual investors negotiating. This is compounded by confidentiality agreements that prevent investors from sharing information and adopting collective position in any negotiation.

2.1.26 First closes, early commitment discounts and speed of fund-raising

Funds are marketed with a specific target minimum and usually a maximum cap. The maximum can be a 'hard cap' that cannot be breached, or a soft cap that is there to guide investors about the fund aspirations but can be extended. Once a fund has commitments over the minimum they may declare a 'first close'. This represents a commitment to investors and funders to proceed with the fund and also acts as a signal to those who may be waiting to see how a fund raising is progressing that the fund is indeed going to be raised.

As the funding environment toughened it has become increasingly common for GP fund managers to offer LP investors preferential terms if they commit to invest before the first close. The intention is to entice investors into the fund as early as possible and to build momentum that enables the fund manager to close the fund-raising as soon as possible. A fast fund-raising is considered a sign of a successful fund manager. Conversely a long fund-raising is deemed to be indicative of a weaker proposition.

2.1.27 How can individual investors invest in private equity funds?

There are retail funds and venture capital trusts that invest in smaller private equity transactions. There are also quoted investment trusts that invest in private equity transactions including larger deals and, as commented on above, both KKR and Blackstone, which are partnerships, have offered interests to the public. However, in general, larger private equity funds have a minimum investment amount that precludes most private investors. Furthermore, managing the drawdown from private investors

would be a significant burden. This minimum varies from fund to fund but a minimum investment of $10m is not uncommon. Furthermore, due to the regulatory protections afforded to retail investors in the UK and Europe, the costs and regulatory burdens of raising retail funds mean that no large private equity fund markets to a retail investment audience. The latest of these regulatory changes, the AIFM, is discussed below.

The flotation of a fund will alter the ability of retail investors to access private equity, but this is not explored in this publication.

In order to provide wider access to private equity funds a number of fund-of-funds have emerged. These allow smaller institutional investors, who cannot justify the costs of an in-house team making private equity fund investments, to collectively invest in the larger private equity funds. However, the fund-of-funds manager will charge a fee (and take a share of any profit) before the investor earns a return and for similar reasons to those above, few are open to retail investors.

In any reasonable sense, other than a few exceptions (eg, indirect investment and, for example, specialist venture capital trusts), the private equity market should therefore be viewed as a wholesale market available only to institutional investors and regulated accordingly.

2.1.28 What is the secondary fund market?

Investors in private equity funds typically make a 10-year commitment to each fund. Compared to many other investment fund types, this is a long-term commitment. However, as we have made clear above, a commitment is not the same as an investment. Investors only invest cash as the fund is drawn down.

For investors seeking to exit from these commitments there is a growing market in private equity fund positions, the secondary fund market, and a number of specialist funds now exist to acquire secondary positions. With the private equity fund manager's consent, the investor can sell to another party both their share of the actual investments in the private equity fund, and their obligation to fund future investments. Historically, the early secondary purchases were generally only of actual investments rather than future commitments and were usually sold at a discount. Today these may be at a premium or discount and may often include the acquisition of the obligation to future funding commitments.

Although the secondary fund market has existed for some time it has been given added impetus in tight liquidity conditions. In some cases, stock market falls meant that some LPs were over-allocated to private equity in relation to their statutory target limits (the so-called 'denominator effect'). In other cases, poor performance of the private equity fund triggered a desire to exit. Other reasons for secondary fund activity concern changes in LPs' investment strategies, regulatory changes and a need to release funds to avoid defaulting on capital commitments. Liquidity in the secondary fund market is constrained by the challenges of valuing funds where selling LPs have a major informational benefit over prospective buyers because of their typically long-term relationship with GPs.

We discuss these secondary fund market transactions in more detail in section 2.5.5.

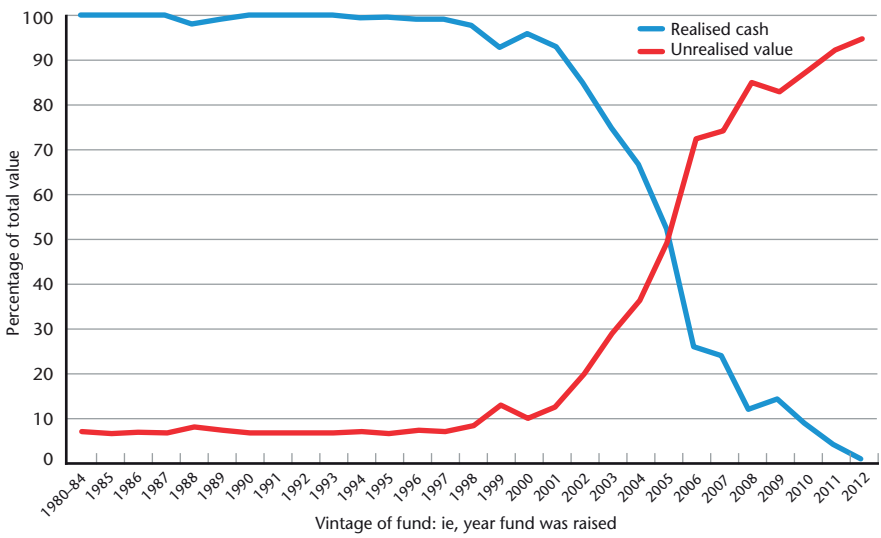
Findings 2.1: Secondary fund market. The academic evidence

There is limited academic evidence on the secondary funds market. Available evidence (Appendix Table 2) indicates that private equity fund interest is more liquid if the fund is larger, has a buy-out-focused strategy, has less undrawn capital, has made fewer distributions and is managed by a manager whose funds were previously sold in the secondary fund market. Private equity funds' liquidity improves if more non-traditional buyers, as opposed to dedicated secondary funds, provide bids and overall market conditions are favourable.

2.1.29 Why do private equity funds value unrealised investments?

Since private equity funds own assets that are not quoted, there is no market price with which to value investments. This creates both accounting and wider commercial issues that are relevant to the debate on disclosure by private equity fund managers. As a number of commentators have remarked, the only value that ultimately matters to a limited partner (or the fund manager) is the difference between the total cash invested in the fund and the total received back once the fund has closed, and so the theoretical value attributed to an investment prior to its ultimate exit may be considered to be of limited practical use. There are some funds that charge fees based on net asset values, but this is not generally the norm.

Figure 2.11: Percentage of value realised and not realised by vintage of funds



Source: BVCA/PwC 2012.

However, since funds are 10-year commitments with a five-year investment horizon or holding period, new funds are always being raised before existing funds are fully realised. This is clearly illustrated in the data above (Figure 2.11). It shows that in funds that were six to eight years old in 2012, between 50% and 75% of the total return in funds is attributable to unrealised investments. Equivalently, only 25%–50% of total return has been received in cash from funds six to eight years old.

Therefore, the valuation of recent unrealised investments is a material piece of information to both the fund manager and potential investors in any fund being raised.

It is common practice for managers to carry out quarterly valuations as part of the reporting process to investors.

This ongoing valuation is particularly important in private equity. There has been a hotly contested finding that the best funds have systematically outperformed the market. The first sign of a breakdown in this finding should be seen in portfolio valuation falls.

2.1.30 How do private equity funds value unrealised investments?

Detailed guidelines intended to represent current best practice on the valuation of private equity investments are published in *International Private Equity and Venture Capital Valuation Guidelines* ('IPEV Guidelines'). In summary the IPEV Guidelines identify six different 'most widely used' methods available to value an investment. Within each method there are a number of variables that require a decision on the part of the valuer.

1. **Price of a recent investment:** when a recent investment has been made in a company, the implied market value of the company in that investment round may be used to value any instrument. In first investments, this means that they are valued at cost. In further investments (for example a development capital or a rescue) the total investment (including any earlier rounds) might be valued at the price of the latest investment.

2. **Earning multiple valuations:** these are commonly used for profitable investments.

   There is an array of alternative methods including:

   (a) P/E ratios: equity value/profit after tax;

   (b) EBIT multiples: enterprise value/earnings before interest and tax;

   (c) EBITDA multiples: enterprise value/earnings before interest, tax, depreciation and amortisation.

   Each calculation can be performed using historical, current, 'sustainable' or projected data.

   It is usual to use comparable ratios derived from the quoted markets and/or relevant recent transactions. Having decided which of the potential comparable market ratios to use, it is normal to apply a discount to the quoted market ratio to reflect a liquidity discount. This discount may be reduced if a fund manager believes a sale or flotation to be imminent.

3. **Net asset valuation (NAV):** where a business is not profitable or carries out an activity that is essentially involved with purchase and management of assets (such as a property investment company) they may be valued by reference to their net tangible assets. Goodwill created by the acquisition should normally be excluded along with certain other intangible assets. As in an earnings valuation based on market comparators, a discount is typically applied to the tangible asset valuation.

4. **Discounted cash flows (DCFs) in the company:** economic theory tells us that the present value of any asset is the value of its future cash flows discounted to reflect the time until the cash is received and the risk that the cash flow will vary. DCFs, therefore, have the strongest theoretical underpinning. However, in practical use they are extremely sensitive to the assumptions made regarding discount rates and timing of cash receipts. Furthermore, there is a requirement to estimate the value of the business at the end of the discrete period for which cash-flow estimates are available. This is itself a valuation estimate.

5. **Discounted cash flows from the investment:** where an investment generates most or all of its returns from reasonably predictable cash payments and relatively little (or none) of its return from a terminal payment on sale, DCFs may be an appropriate valuation method. Loan stock, mezzanine and preference share investments are more suitable to this approach than most equity instruments.
6. **Industry benchmarks:** some industries have commonly quoted metrics that are not based on cash generation or profitability. Multiples of sales are often quoted for companies that are either loss making or where profits are not disclosed. Similarly the growth of new subscriber businesses was characterised by the use of 'value per subscriber'. All of these methods are proxies for the future cash generation that will accrue from the business. In general, the further the valuation metric moves away from being based upon future cash generation, the greater the likelihood that it will be proved to be inaccurate.

Where the selected methodology results in an estimate of the enterprise value (EV) of the underlying business (for example EBIT/EBITDA multiples or DCF), the EV is apportioned between the holders of debt and equity instruments in accordance with the respective claims of those instrument holders (having due regard to the impact of any ratchet arrangements and/or outstanding options) assuming a sale of the business at its estimated EV.

2.1.31 Understanding private equity portfolio valuation movements

When looking at the movement in the valuation of a private equity portfolio, there are four classes of variable that contribute to the change in the equity value:

Changes in valuation method + Changes in company performance + Change in external market comparators + Change in net debt

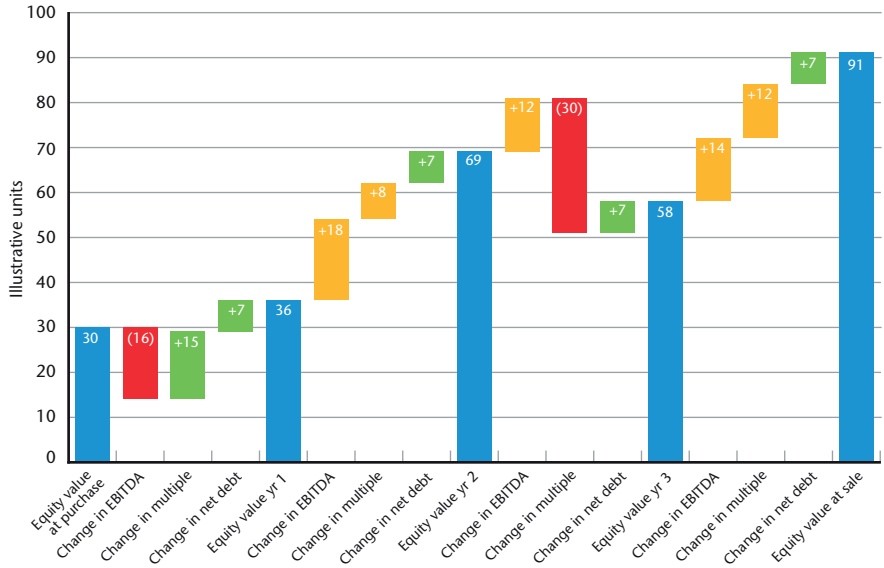
The first element is almost always relevant to funds in their early stages. All first investments in any fund are normally initially valued at cost. Once the first accounts after the investment are received, the fund manager will generally revalue based on the investment performance. Note that the audited accounts relate to the prior period and may therefore have a limited relevance to current trading. This creates significant timing lags if only audited accounts are used. If unaudited management accounts are used to adjust for this timing lag, a lack of external verification of the data used to underpin valuations arises.

The basis of valuation therefore fundamentally changes from one based on the actual price paid to some proxy for an external market value.

Many private equity investments are based on an investment thesis that a business requires restructuring or realignment: 'one step backwards to take two steps forwards'. In such cases the actual performance of the business, and its lagged valuation, may fall before the benefits of any repositioning emerge.

Valuations therefore move for a mix of reasons, some related to the performance of the business, some the external market and some purely due to a change in valuation method.

Figure 2.12: Illustrative equity valuation bridge



Source: Gilligan and Wright.

Furthermore, the significant costs and transaction taxes paid in completing a deal must be recovered before any value accrues to the equity holders. Other things being equal, it might therefore be expected that the value of an investment would fall after completion (by at least the amount of the costs) before recovering as a result of the planned restructuring or realignment (Figure 2.12).

This timing effect is compounded by the widespread belief that 'lemons ripen faster than plums': failures (lemons) emerge quickly whereas successes (plums) take longer to fully emerge.

2.1.32 Valuation of limited partner holdings: the J curve revisited

In addition to the change in the valuation of the portfolio of investments, the value of a limited partner's holding will be further impacted by the timing differences between fees paid to the manager and any value growth, realisations and yield from the investment portfolio. Management fees are higher during the investment phase of any fund and generally decline when the fund closes to new investments and is concentrated on realising the investments made. Therefore, with investments valued at cost, the investors will generally see a decline in the return of their investment due to fees in the early years of any particular fund.

When accounting for the total return from an investment portfolio the effects of all revenues including fees, valuation movements and realisations are brought together and the movement in the portfolio at value calculated.

Total return = Revenue profit/(loss) + Realised profit/(loss) over valuation + Valuation increase/(decrease)

The cash flows of the fund are initially negative as investments are made and will become positive once the investments generate yield and are realised. This, coupled with the fees noted above, results in the cash flow profile known as the J curve, as illustrated above. The difference between the total return and the cumulative cash flow will, in all probability, be further exaggerated as the total return statement should include a discount for non-marketability, whereas the realised cash flows include the actual realised value of the investments, which, other things being equal, should be higher. By the close of the fund the cumulative cash flows equal the cumulative total return.

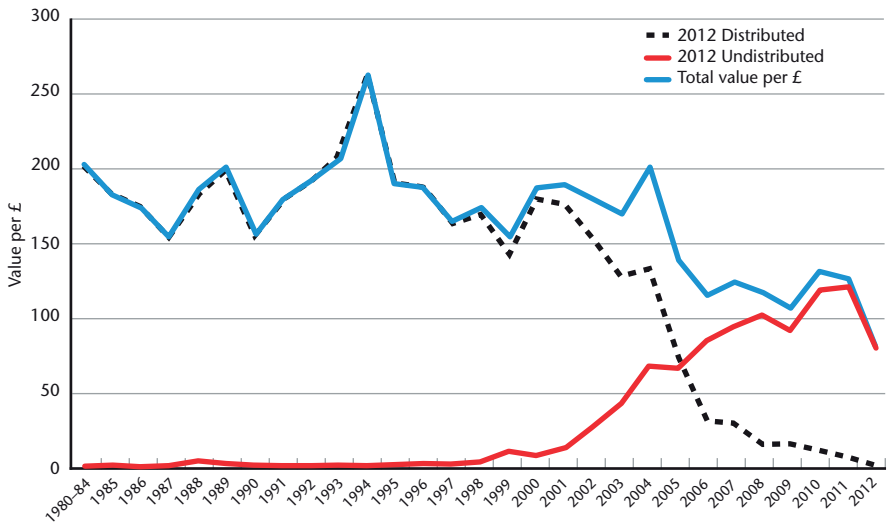
2.1.33 What are DPI and TVPI as measures of return?

Various measures are applied to monitor and adjust for the timing differences between total return and receipt of cash flows. We describe and illustrate the most commonly used measure, IRR, in section 3.

One of the simplest trend measures is the value per £1.00 invested both at valuation and including realisations as illustrated in Figure 2.13. This measure captures the trends in value appreciation in the portfolio as it matures.

In the jargon of the industry, DPI measures distribution as a percentage of paid-in capital. TVPI measures total value as a percentage of paid-in capital. Both are measures of value per £ or other currency.

Figure 2.13: Value per £ invested in UK private equity firms: distributed and undistributed value by fund vintage as at 31 December 2013



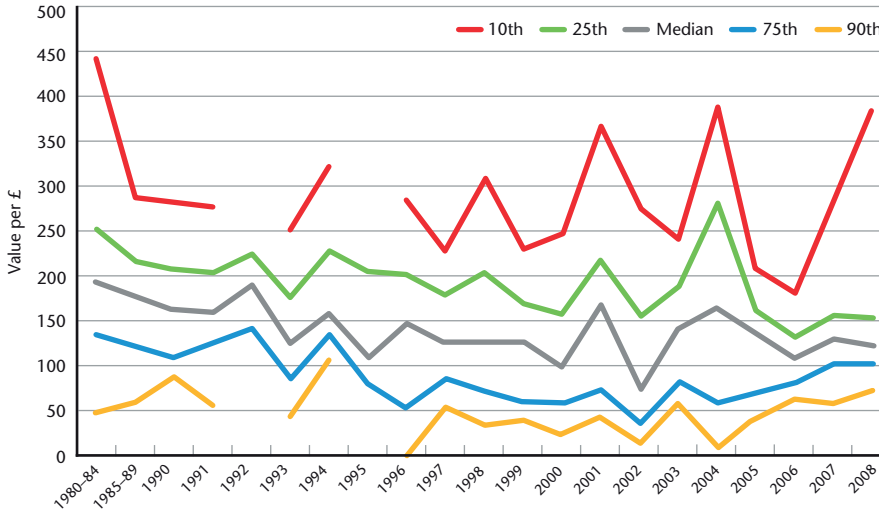
Source: BVCA/PwC 2012/2010/2009/2008.

2.1.34 What is the range of returns for investors?

It is important to understand both the overall industry returns and their volatility over time. In addition, the variation in returns between the most successful and least successful fund managers is a key statistic to understand the performance and risks of the industry. Data on the performance of mature funds is presented annually by the BVCA.

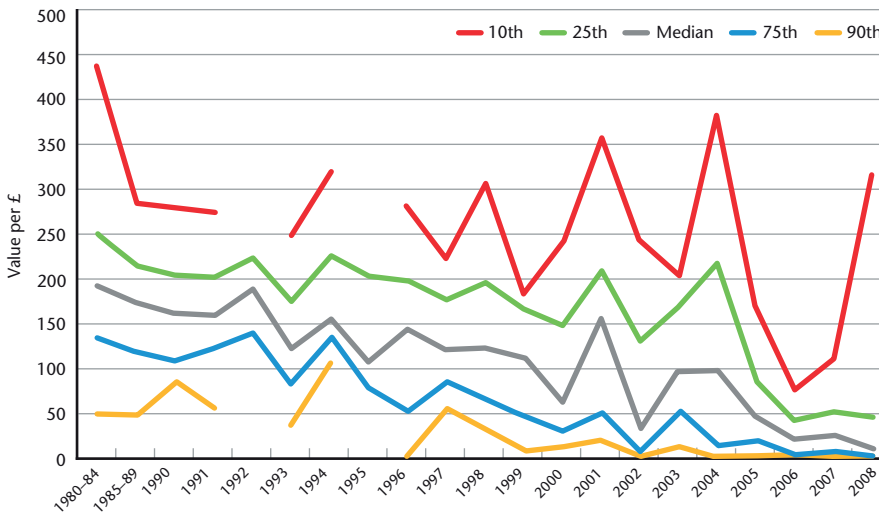
The latest data was published in July 2013, covering periods up to 31 December 2008 and is summarised in Figure 2.14 and Figure 2.15. These illustrate the average (median) return private equity funds, and give data on the distribution of the returns of the various funds. Later returns are not published because of the J curve effect distorting the returns.

Figure 2.14: Distribution of returns to mid–large buy-out funds by vintage of fund – total value per £ invested (funds over six years old)



Source: BVCA/PwC.

Figure 2.15: Distribution of returns to private equity funds by vintage of fund – cash distributed per £ invested (funds over six years old)



Source: BVCA/PwC.

This limited data and further data available from both the BVCA and EVCA illustrating the distribution of IRRs between upper quartile/decile funds and lower quartile/decile funds suggest that:

- returns are volatile;
- returns have been falling over time in all percentiles.

Thus, while the median outcome in funds has favourably compared with many other investment categories, the variance of outcomes is wide. As these are measures of funds, not of fund managers, it is difficult to extrapolate these conclusions further. However, it is clear that there are very material variations in performance between funds.

According to the BVCA 'Performance Measurement Survey and Report on Investment Activity' (for 2012) over a 35-year horizon in a dataset containing 454 separate funds:

- nearly half of all private equity funds pay no carried interest;
- one in four of funds loses around 1/8th of its capital;
- one in 10 of funds loses around 1/2 of its capital.

The academic studies of private equity fund performance are reviewed in more detail below.

Findings 2.2: Do investors earn superior returns? The academic evidence

Private equity funds provide extensive information to their investors, but hitherto they have provided very little information to any external parties, which has made it difficult independently to assess the performance of funds. The available data is contradictory (Appendix Table 2). Evidence sponsored by the private equity industry trade associations indicates that private equity funds outperform alternative forms of investment such as quoted shares, although the variation between the top-performing funds and the others is very wide. Academic evidence attempts to adjust for risk and fees, as well as whether investments are realised or not. However, considerable debate has now emerged amongst a plethora of academic studies about the about the performance of buy-out funds. Much of this debate centres on the problem that apparent over- or underperformance may be down to the database being used. While proprietary databases, such as those held by funds-of-funds provide access to performance data that is not publicly available, they may potentially be biased depending on the scope of the funds that are covered. Initial US evidence showed LBO fund returns (gross of fees) exceed those of the S&P 500 but that net of fees they are slightly less than the S&P 500. After correcting for sample bias and overstated accounting values for non-exited investments, separate evidence shows that average fund performance changes from slight over-performance to underperformance of 3% pa with respect to S&P 500. There is also quite strong evidence that some buy-out fund managers generate more from fees than from carried interest. Buy-out fund managers earn lower revenue per managed dollar than managers of VC funds.

More recent studies have cast doubt on the underperformance, with several finding over-performance using various stock market comparator benchmarks using more robust data sources and one study finding a zero alpha gross of fees. However, it is important to adopt the appropriate benchmark given that buy-out funds typically invest in smaller deals than the S&P 500. Adjusting for the size premium, there is some evidence that the over-performance disappears.

The timing of fund-raising may also be important: private equity returns on buy-out funds appear to be higher for those funds raised in the 1980s than those raised in the 1990s and 2000s ie, there is a declining trend over time. Funds raised in boom times (which generally correspond to the second halves of the past three decades) seem less likely to raise follow-on funds and thus appear to perform less well. These studies also find that the top-performing funds had enduring outperformance, notably top decile rather than top quartile funds.

Findings 2.2: Do investors earn superior returns? The academic evidence (continued)

It has been suggested that this long-standing relationship may be breaking down and that outperformance in many funds will no longer endure. Some academic work suggests that, historically, most successful funds have become too large, too fast. There are indications, however, of diseconomies of scale among private equity firm investors as investments held at times of a high number of simultaneous investments underperform substantially, with diseconomies being highest for independent firms, less hierarchical firms (in the organisation sense), and those with managers of similar professional backgrounds. The most recent study suggests that persistence in buy-out funds has weakened and barely persisted post-2000, suggesting that previous quartile performance is not a strong predictor of current fund quartile performance. It is also recognised that the ability to raise a further fund is dependent upon past fund performance. Turnover of fund professionals between funds is associated with higher performance, especially if professionals with operating experience are recruited.

Direct investments by LPs

Although private equity firms are specialist intermediaries with the expertise to select and add value to portfolio companies, high fees and the poor performance by some private equity firms has been behind an increase in direct investments by LPs. A number of Canadian pension funds, for example, have established direct investment businesses. In principle, direct investment in portfolio companies, either as sole investor or as a co-investor with a private equity firm, provides greater control for the LP in the selection of particularly attractive investments while saving on fees. As private equity fund performance is highly cyclical, direct investment may also enable LPs to better time the market and manage their risk exposure if LPs are under less pressure to invest at peak times than are LPs. On the other hand, LPs may be less skilled in picking attractive investments, unless they can recruit and reward professionals with this expertise, which may be difficult within the traditional structures of LPs.

Findings 2.3: Direct investments by LP. The academic evidence

There is limited academic evidence on the returns to direct investments by LPs. The main available study (Appendix Table 2) shows that solo investments by LPs outperform co-investments. Where there is outperformance this appears to be driven by deals where informational problems are not severe, such as where the deals are late stage so that the investee company has a track record, or are located close to the investor and when deals are undertaken in peak years. The poor performance of co-investment deals appears to be due to selective offering by private equity fund managers to LPs of large deals.

2.1.35 Banks and other lenders

What role do banks play in private equity?

Banks provide the debt in buy-outs and this debt may take many forms and be provided by many different market participants including one or more of commercial banks, investment banks, dedicated mezzanine providers and hedge funds or similar specialist funds.

Many smaller loans are syndicated within the traditional banking industry. During the most recent buy-out boom, larger loan facilities frequently had many different 'layers', some of which were structured to be sold through global capital markets via a CDO as described below.

More information about the process and logic of structuring of layers of debt is given in section 3.

What is leveraged lending?

There is no hard and fast definition of what is and is not leveraged lending. In one sense all lending is leveraged as the use of any debt magnifies the returns (both positive and negative) when compared to financing with only permanent equity.

However, the industry generally defines leveraged lending with reference to either the post transaction debt: total assets ratio (the 'gearing ratio' in the UK, the 'leverage ratio' elsewhere), or the ratio of EBITDA: total debt (the EBITDA multiple).

Where total debt is over 50% of total assets or borrowings exceed around 3 X EBITDA, most banks would define and manage the relationship as a leveraged finance loan. Other definitions might include the credit rating of a traded bond or the margin on a particular loan. Whichever definition is used, the term attempts to capture the fact that a leveraged loan is deliberately structured with higher risks and rewards than a 'non-leveraged loan'. This contrasts with distressed loans that are loans that become higher risk rather than being structured as such.

How did the banking market change?

In traditional banking, a bank will lend and build a portfolio of loans, although some of the larger loans might be shared between banks through a process of syndication. In this model, bankers are constrained by the fact that any losses will fall on their own balance sheet. In recent years banks changed and began to act as arrangers of loans rather than primarily as lenders. The proportion of loans held by the arranging or 'lead' bank after a transaction fell throughout the late 2000s. In this 'arranger model' of banking, the incentive is to maximise the amounts lent, subject to the constraint of being able to syndicate the loans to other banks (and other investors) such as CDOs.

To achieve a wide syndication, a loan must either be actively sold to the market by a syndication team within a bank or alternatively sold to the public markets as a rated bond issue. If the loan is sold to the market by a syndication team the bank gives a limited number of banks access to its due diligence. The appraisals it has carried out are made available usually including the opportunity to meet the management of the company prior to investing in the loan issue.

If a loan is sold to the public markets as a rated bond issue a credit rating agency will be retained by the lead issuer and will undertake its own credit assessment and grade the loan according to market norms. The arrangement between the rating agency and the issuer has come under some scrutiny. The rating agency's fees are paid by the sponsor of the bond being issued. The agency is therefore incentivised to give a rating that is consistent with the issuer's own assessment, or better. The constraint on this favourable incentive was argued to be reputational risk: rating agencies would not favourably rate due to the perceived risk to their reputation. This argument now looks hollow. Rating agencies are indemnified against the risk of errors arising from poor or inaccurate data by the sponsors.

The bank's rewards and the risk: the lead bank's major source of income becomes fees from arranging the debt and syndication rather than interest from lending a portfolio of loans. In the first edition of this work we noted that there was very little academic research around the impact of this gradual change in banking incentives and the potential impact on risk and conflicts of interest within the arranging and syndications markets. Since we wrote the first edition, it has become apparent that the conflicts we alluded to within the arranger model led to systematic risk in the banking market that manifested itself in the credit crunch.

Bank covenants: if a business with borrowings does not perform to plan, a series of monitoring tools will alert the lending banks. These ratios, or financial covenants, are agreed prior to a loan being granted. If a company breaches one or more of these agreed limits, the banks will typically have a series of options available to them. These include renegotiating the loan package or appointing an administrator to sell the business or its assets to repay the loans. The negotiation of the banks' covenants is therefore a crucial part of the management of the risk of a transaction for the company, the banks and the equity investors. This is described in more detail in sections 3 and 4.

Where the covenant arrangements are either not tested as frequently as industry norms or the agreement allows the private equity funds to inject new capital to rectify any breach ('equity cure'), the loans are known as covenant light or 'cov-lite' loans. Post-credit crunch, cov-lite disappeared from the banking market but it is now returning. However, there is a significant volume of cov-lite loans in existence. These therefore continue to change the risk allocation in favour of the borrowers and against the lenders.

Why did the banking market change?

Syndication has advantages to both the arrangers of the syndication and the participants in the syndication. For the arrangers a new business model began to emerge that generated higher returns on assets than had been achievable in the traditional banking model. Lead arrangers not only generated lucrative fees from arranging the loans and underwriting the facilities prior to syndication, they were also able to force cross-selling of other banking services to the borrowers. It is often a condition of a loan arrangement that certain other banking services are taken with the arranger – hedging, insurance or other lucrative broad advisory services. Conversely, the largest corporate borrowers often force banks to participate in their bond issues if they wish to provide other banking services. It is noticeable, for example, that the largest private equity funds often have limited partners whose core business includes being participants in the leveraged finance market. Such mutuality, or conflict, of interest and influence is of no great surprise.

In buy-outs, by taking the underwriting risk on the whole debt package, lead banks are able to capture both the underwriting profit and a significant portion of the overall banking business of the buy-out group. This further enhances the returns generated by banks minimising the amount of capital tied into any particular loan package post-syndication.

The syndication model therefore allowed banks with origination teams to increase their ability to sell a broad range of services while reducing the amount of capital permanently tied up in the provision of any particular facility.

For syndicate members the process also has advantages. Firstly, it allows smaller financial institutions whose balance sheets are too small to allow them to participate in lending to the largest borrowers to gain access to this market. Secondly, it allows institutions to diversify their portfolio to include markets within which they have no origination teams. This was a particularly important incentive when global yields on bonds were low and therefore investors generally, including banks, were seeking to achieve higher yields.

The market therefore allowed institutions of all sizes to gain exposure to a wide array of risks.

What are the risks of leveraged lending?

There are generally six recognised risks in leveraged (or indeed any other) lending:

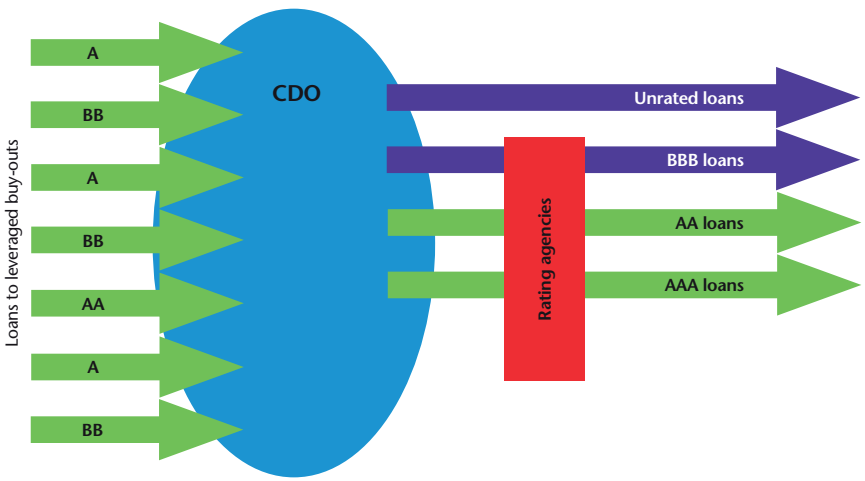
1. Credit risk arises in any loan and represents the risk to capital and income of the lender due to the risk of the borrower's inability to pay. This includes the underwriter's risk prior to the syndication.

2. Liquidity risk arises when a bank mismatches the term of its assets and liabilities. Where it has short-term borrowings supporting long-term loans a liquidity crisis can cause a bank to collapse.
3. Price risk arises in underwritten syndications because the terms to the borrower are agreed prior to syndication. Where the market assesses the risks to be different to the underwritten assessment of the lead bank, the price paid for any particular bond may fall and the underwriter will incur a loss.
4. Reputational risks are the effect of adverse public perception on the prospects of an institution. In leveraged finance this includes the particular reputational damage that can occur when complex structures are put in place that are perceived to be designed to avoid moral obligations, such as the creation of offshore special purpose vehicles that are characterised (often inaccurately) as tax avoidance schemes.
5. Strategic risks include an organisation's ability to manage its exposure to the particular market and the changes within the market that it operates. This might include, for example, having an organisation structure that effectively monitors and reports on a loan portfolio to enable decisions to be made in a timely and informed manner.
6. Compliance risks arise when new and innovative financial products are developed that have not previously been specifically considered by the regulator of a market. The issuer of any syndication will take responsibility for the legality of the transactions that are being completed. They have a risk that any syndicate participant will pursue them for damages in the event that an arrangement is misrepresented or is illegal.

In the credit crunch many institutions experienced a variety of these risks.

2.1.36 What are collateralised debt obligations, collateralised loan obligations and structured investment vehicles?

Figure 2.16: Schematic of a CDO/CLO/SIV



Source: Gilligan and Wright.

Collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs) together with structured investment vehicles (SIVs) are important and little-understood fund structures (Figure 2.16). CDOs have existed for many years as vehicles to enable banks to sell loan obligations, thereby increasing capital efficiency and returns on capital, but have grown in significance dramatically in the last few years.

For simplicity we ignore the terminological differences between CDO/CLO and concentrate on the economics of the transaction rather than the assets or management style of the fund. The SIV is simply the legal entity that takes in loans and assets that are blended together to create the CDOs.

There are basically two forms of CDO.

- **Balance sheet deals:** these have existed for many years and involve a bank selling a portion of its loan portfolio to a SIV that pays for the assets from the receipts of a bond issue, or a series of contracts to transfer the default risk to other investors, usually by a credit default swap (an insurance policy against non-repayment). These deals are usually constructed to allow a bank to manage its regulated capital base efficiently.
- **Arbitrage deals:** these structures attempt to capture the difference between the yield of an underlying asset and the cost of the bonds issued by the SIV to acquire the assets (or the price paid for the asset) and can be broadly characterised as being of two forms.

  The first involves a trading strategy where the SIV actively trades bonds to generate a return. These types of vehicle were heavily involved in the sub-prime lending market and are the focus of much public discussion.

  The second are cash-flow deals. These are most relevant in the LBO syndication market. In these transactions, the SIV participates in the debt syndication. It builds a portfolio of loans financed by its own equity and bridge finance from its bankers. Once the portfolio is large enough it will issue a series of bonds backed by the loans. The senior bonds are rated by a credit rating agency and are ranked first. These are bought by investors in the bond market. Rated mezzanine bonds are also issued that rank after the senior bonds. These have a higher interest rate, but carry more risk and are sold to investors seeking higher yield assets, often hedge funds and alternative asset investors. Finally, any profit or loss on the underlying assets is paid to unrated bonds ranking last. These bonds have returns and risks that are comparable with equity. They are sold to investors seeking equity returns and usually held by the SIV manager. This process of so-called 'slicing and dicing' enables risk to be dispersed throughout the market. It also makes it exceptionally difficult to know exactly where risk resides.

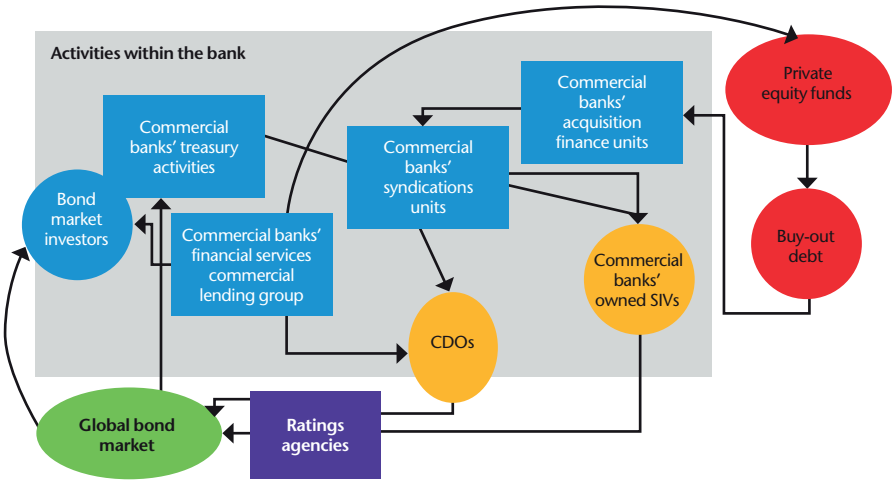
CDO managers earn returns in the same way as private equity fund managers; they receive fees and a carried interest. Indeed a number of CDO funds are sponsored and managed by teams affiliated with private equity fund managers and are invested in by them.

What went wrong?

Syndication: the broad syndication of loans throughout the financial market has had two major consequences. First, the total risk was disseminated across many institutions, reducing the impact of any one corporate default or failure. Second, it became increasingly difficult for observers of the markets to establish where the risks were actually held within the financial system. Figure 2.17 below simplifies the flows to illustrate how risk is disseminated from the original lenders to a wide variety of institutions and how that risk can flow back to the originating banks.

It shows that a risk that is securitised through a CDO or a SIV enters the global bond market 'wrapped' in a credit rating issued by a rating agency. Where the issuer is a CDO or a SIV, the bond will be a synthetic amalgam of various loans held within the issuer's portfolio.

Figure 2.17: Flow of risks from original lenders through securitisation to bond markets



Source: Gilligan and Wright.

During the period prior to the credit crunch, it was argued that this dispersal of risk through the enlarged global financial system reduced systemic risk. We now know this to be incorrect. The lack of transparency created by the process of securitisation created a market in which a sharp fall in confidence resulted in a dramatic reduction in liquidity in the wholesale banking market.

This happened because institutions were unable to confidently price the synthetic products created by the securitisation process. When the pricing mechanism fails, free markets fail to clear. This in turn created short-term funding crises in the banks and other financial institutions that were reliant on wholesale funding for their day-to-day operations. In essence, the greater the reliance on wholesale funds, the greater the bankruptcy risk caused by the market failure attributable to the lack of accurate information.

Many leveraged loans took advantage of the growth in the number of participants in the bond market that had grown largely on the back of the US housing market. As the sub-prime market grew there was increased liquidity at its margins that the arrangers of leveraged loans took advantage of. They used the same process as was employed in the mortgage market to distribute loans widely. Lead banks increasingly used rating agencies to issue traded bonds either directly in the largest buy-outs, or in the upper-mid market by a process of securitisation undertaken within CDOs and similar special purpose vehicles (SPVs).

Key to the ability to achieve this dispersal of risk is the rating agencies' ability to accurately rate the commercial paper issued so that the market prices it appropriately. This ability appears to have been seriously compromised.

How much leveraged lending did banks undertake?

In the period leading up to the boom, the amount of banks' exposures to LBOs rose 17% from €58bn at June 2005 to €67.9bn at June 2006 as reported by the FSA (now FCA). These exposures were relatively concentrated, with firms' top five deals representing on average 47% of their exposure. Banks' exposures were also increasingly complex with enhanced use of mezzanine, bridge and payment-in-kind (PIK) debt. These instruments are described and discussed in sections 3 and 4.

The FSA (now FCA) argued that this was a response to the appetite in the institutional debt market for such products prior to the credit crunch.

As discussed above, the banking market saw a change in the business model used and banks were increasingly distributing the debt that they underwrote. Following the credit crunch of 2007–2008, banks significantly reduced their exposure to leveraged buy-outs and new forms of lenders have emerged to fill the gap left.

2.1.37 Non-bank lenders

With the retrenchment of the traditional leverage finance providers, an opportunity arose for the establishment of new non-bank lenders to private equity. These funds use a similar model to the private equity funds to raise debt funds. Non-bank lenders differ from banks as follows.

Firstly most new lenders were originally targeted at the upper-mid market and beyond. There are no significant competitors in the smaller buy-out market. Secondly these funds do not generally recycle their investments like a bank and they therefore prefer to leave capital invested for longer. This creates risk that justifies higher costs of funds. You therefore see the use of so-called 'unitranche funding' which has a single repayment (tranche) payable at the end of the life of the investment. These structures are very like interest-only mortgages in their risks.

2.2. Advisers and other service providers

Private equity funds outsource many functions. Unlike larger banks, few private equity funds have in-house accountants and lawyers, and most outsource as much as possible. These outsourced service and advisory relationships fall into three broad categories – services, transactions advisers and fundraising advisers – which are explained below.

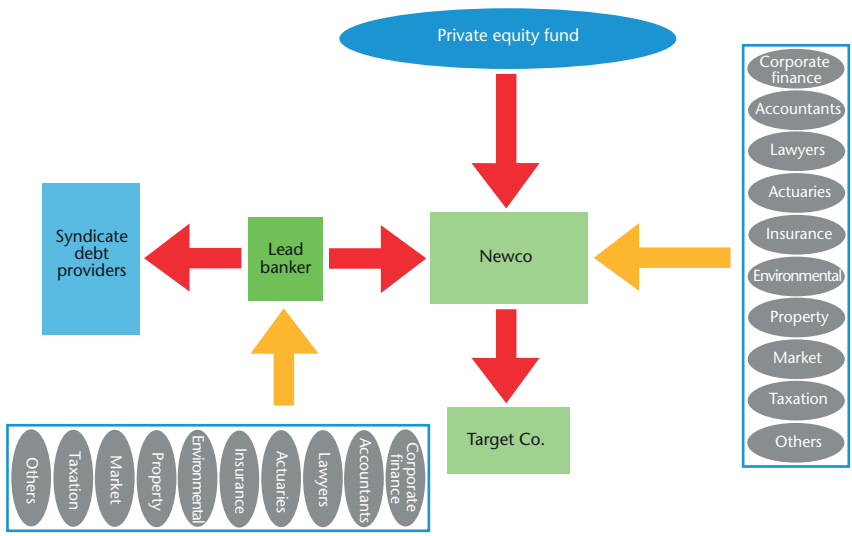
2.2.1 Who provides outsourced services?

These are providers to the fund management business providing day-to-day support to management and reporting of the funds business. They are in principle no different to any other business.

2.2.2 Who are transactions advisers?

Transaction advisers generally include investment bankers, accountants and lawyers.

Figure 2.18: Illustrative advisers to a transaction



Source: Gilligan and Wright.

- **Investment bankers:** both a source of deals for the private equity fund, when the investment bank is advising the vendor of a business, and a provider of advisory and distribution services (ie, syndication) when advising the private equity funds. Thus in Figure 3.1 an investment bank may be providing advisory services to the Newco and private equity fund at the same time as underwriting the banking and arranging the syndication of the transaction debt. This creates a complex series of incentives: the corporate finance and syndication fees are, on the whole, payable only if a transaction completes. However, if a transaction that is not attractive to the market is arranged, the underwriting arm of the bank will be left holding the majority of the transaction debt. The incentives are therefore to maximise the transaction flow subject to the limitation of the appetite of the syndication market for debt. The bubble of the late 2000s in the secondary banking market released the normal action of this constraint and allowed the almost unrestrained growth in the size and scale of buy-outs prior to the credit crunch.

  Furthermore the lucrative fees for advising and arranging the subsequent sale or flotation of the business will depend to some degree on the reputation for quality that an organisation or individual builds up.

- **Accountants:** provide due diligence and taxation advice on transactions. The corporate finance advisory businesses of the accountants also provide similar advisory services to those of the investment banks mostly in the mid-market. The accountancy firms argue that they provide advice that is independent of the distribution capacity that is provided by the investment banks. However, the accountancy firms sometimes provide both advisory and due diligence services to the same transaction. Where this is the case the relative size and contingency of the fees for these services needs to be considered to avoid the perception or actuality of a conflict of interest.

  Many larger private equity funds have sought to maximise the incentive of their due diligence advisers to be objective by forging long-term relationships with one or two providers. In these arrangements it is argued that the volume of transactions that any active private equity fund pursues will compensate the due diligence providers for the losses associated with those that do not complete successfully.

  Ongoing audit and tax advice may also be provided to individual investee companies, the funds and the partners of the funds (subject to independence regulations). Some of the large accountancy firms also operate fund placement businesses that assist in raising private equity funds.

- **Lawyers:** providers of legal and tax advice on transactions and fund-raising and structures. Every party to each contract in a transaction will generally have a legal adviser.

2.2.3 Who are fund-raising advisers?

Placement agents are used by many funds. These are specialist advisers who provide assistance in raising funds and provide advice and access to potential investors in private equity funds globally. As the market for private equity has matured, the role of placing agents has migrated from being one that primarily consisted of broking investments by potential limited partners, to both broking and project managing the process of fund-raising.

Potential investors are naturally keen to have comprehensive information on the track record of general partners and to have access to the key people behind whom they are potentially investing. These key individuals also have to manage the portfolio and new business activities of their funds. As funds have grown in size a fund-raising specialism has

emerged both within the funds themselves and outside the funds to efficiently manage the time-consuming process of fund-raising.

Placement agents and placement fees scandal: as funds grew, and the investing community became increasingly international, it became common for private equity managers to retain placement agents to assist in the arranging of new funds. These agents were rewarded with commissions if they brought new investors to the funds being raised. They were especially important if funds were being raised in countries where the fund managers themselves were not known, for example European fund managers seeking US investors for European-focused funds. In the US in a series of scandals and criminal cases it became apparent that placement agents had been lavishly entertaining representatives of some of the large investors in private equity. Subsequently allegations were made that commissions were being shared with the investor's representatives. The US acted swiftly to close down the risk of corruption by banning commissions to placement agents.

2.3. Employees and other stakeholders

2.3.1 What is the impact of private equity transactions on wider stakeholders?

The wider stakeholders in the business including the employees, customers and suppliers, are generally not party to the negotiations in a buy-out. In the case of quoted companies there are strict rules regarding confidentiality of price-sensitive information that preclude wider involvement.

In the UK where the assets of a business are sold rather than the shares in the business, there is a statutory right for employees to be consulted regarding any change in employment terms under the Transfer of Undertakings (Protection of Employment) (TUPE) Regulations.

2.3.2 What is TUPE and when is it applied?

TUPE legislation is designed to protect UK employees from being adversely impacted by the sale of businesses and/or their assets rather than a sale of the shares in the company. TUPE was established in 1981, revised in 2006 to incorporate the EU Directive on Acquired Employment Rights and amended by the Collective Redundancies and Transfer of Undertakings (Protection of Employment) (Amendment) Regulations 2014.

Employees have a legal contractual relationship with the company that employs them. This is embodied in their employment contract and is supplemented by protections guaranteed by employment law. When shares are sold and the ownership of the company transfers to new owners, this has no impact on the contractual relationship between the employee and the company being sold: the legal relationship remains unchanged and is legally identical before and after a sale. If a purchaser subsequently wishes to change any employment conditions it must do so in exactly the same way as if no sale had occurred.

If the assets or the business undertaking are sold rather than shares, the employees will have a new contractual relationship with the acquiring company. They will cease to be employed by their former employer and become employees of the company that bought the assets or undertaking.

TUPE is designed to protect employees from employers who seek to use the change of legal employer to vary the employment terms or to use the sale to dismiss workers. TUPE gives employees an automatic right to be employed on the same terms (with the exception of certain specific occupational pension rights which are outside the scope of this report) by the new employer. These rights include the right to be represented by a trade union where the employees transferred remain distinct from the employees of the

acquiring company. This is almost always the case in a private equity transaction because Newco has no business prior to the transaction, and therefore no employees other than those acquired as part of the transaction. The regulations apply to all companies and public bodies without exception.

The regulations require that representatives of the affected employees be consulted about the transfer by the employers. They have a right to know:

- that the transfer is to take place, when and why;
- the implications for the employees legally, socially and economically; and
- whether the new employer intends taking any action that will have a legal, social or economic impact on the employees.

TUPE also places obligations on the selling employer to inform the acquirer about various employment matters.

Findings 2.4: Do private equity and buy-outs adversely affect employment? The academic evidence

Evidence on the effects of buy-outs on employment is mixed and inconclusive (Appendix Table 3 Panel A). Some US studies from the 1980s report small increases in total firm employment following LBOs. Others report that buy-outs do not expand their employment in line with industry averages but that non-production workers experience the largest fall over a three-year period, while employment of production workers was unchanged. Recent US plant-level data show that employment grows more slowly in private equity cases pre-buy-out and declines more rapidly post-buy-out but in the fourth or fifth year employment mirrors that in non-buy-out control group firms. Existing buy-out plants create similar amounts of jobs to control group forms while greenfield buy-out plants create more jobs. Early firm level UK evidence relating to the 1980s suggested that job losses occurred most substantially at the time of the change in ownership and then began to rise. UK evidence from buy-outs completed over the period 1999–2004 shows that employment growth is 0.51% higher for MBOs after the change in ownership and 0.81% lower for MBIs. More detailed recent data also indicates that employment in MBOs dips initially after the buy-out but then increases, on average. In contrast, for MBIs, the employment level remains below the pre-buy-out level. The majority of both MBOs and MBIs show an increase in employment. The relatively small number of MBI/IBOs involving majority private equity acquisitions of listed corporations tend to experience employment falls in the year immediately after the deal compared with non-acquired firms and generally fail to show subsequent increases in productivity or profitability. Further evidence suggests that private equity-backed buy-outs have no significant impact on employment while traditional acquisitions have negative employment consequences. The impacts of buy-outs on employment growth rates are similar to those for traditional acquisitions. A private equity deal would be unlikely to occur if the pre-buy-out firm was performing optimally because there would be few performance gains to be obtained from restructuring. As on average MBO/I plants have lower productivity before the buy-out than their non-buy-out counterparts, it is not surprising that some labour shedding occurs. However, shedding labour at the time of a buy-out helps set the firm on a more viable footing, reducing the likelihood that the firm will subsequently fail with an even higher loss of employment. Where there is little alternative except closure, a private equity deal may have its attractions. US evidence suggests that private equity accelerates both job destruction and job creation resulting in productivity gains.

Findings 2.5: Do private equity and buy-outs adversely affect wages? The academic evidence

US studies from the 1980s indicate a decline in the relative compensation of non-production workers (Appendix Table 3 Panel B). Evidence from the late 1990s and 2000s in the UK shows that the average growth in wage levels in MBOs and MBIs is marginally lower than in firms which have not undergone a buy-out. Buy-outs have more negative wage effects than traditional acquisitions. MBIs typically are underperforming problem cases prior to the change in ownership, that require more restructuring and which generally have a higher failure rate than MBOs. Pre-buy-out remuneration may not have been sustainable if firms had been underperforming. The impact of private equity-backed deals, may be different from that of non-private equity-backed deals, but preliminary evidence indicates that this difference disappears once the problem that certain types of firm are selected as buy-outs is taken into account. Data is not available concerning whether buy-outs had a higher or lower wages trend than non-buy-outs and hence whether the position is worse, better or the same after buy-out. It is also problematical to integrate the weekly/monthly wage aspects of remuneration and any benefits from the introduction of employee share ownership schemes at the point of the buy-out; the latter may substitute for standard wage payments which may not necessarily be the same in non-buy-outs. Thus, these findings are likely to bias against finding positive wage effects due to buy-outs if they are more likely to use such schemes than non-buy-outs. In summary, the results are again inconclusive.

Findings 2.6: What is the impact of private equity on human resources management? The academic evidence

Buy-outs in the UK and the Netherlands result, on average, in an improvement in human resource management practices (Appendix Table 3 Panel C). Buy-outs in general result in the adoption of new reward systems and expanded employee involvement, but the effects depend on the type of buy-out. 'Insider' buy-outs and growth-oriented buy-outs had more commitment-oriented employment policies. Preliminary evidence also suggests that buy-outs backed by private equity firms report fewer increases in high-commitment management practices than those that are not private equity backed. Employees in UK MBO firms tend to have more discretion over their work practices than comparable workers at non-MBO firms, with skilled employees, in particular, having low levels of supervision at MBO firms.

Recent pan-European evidence from managers finds that private equity investment results in negligible changes to union recognition, membership density and attitudes to trade union membership. Managers in firms recognising unions after private equity buy-outs do not report reductions in the terms and conditions subject to joint regulation. Under private equity ownership more firms report the presence of consultative committees; managers regard these as more influential on their decisions, and indicate increased consultation over firm performance and future plans. Comparing industrial relations changes in different social models in Europe, the recent evidence suggests private equity firms adapt to national systems and traditional national industrial relations differences persist after buy-out. Systematic evidence is lacking however on the impact on human resources management during the recession.

2.4 Taxation

The structuring of a fund will have a direct impact on the tax position of the various stakeholders involved. It is therefore important that a fund is structured to be attractive based on each stakeholder's relationship with the fund.

Below we consider the tax position of three classes of stakeholder:

2.4.1 investors in a private equity fund;

2.4.2 private equity executives who will manage the fund; and

2.4.3 investee portfolio companies.

2.4.1 Investors in a private equity fund

Any fund must present an attractive investment opportunity for an investor. The way in which returns to an investor are taxed will directly affect the quantum of the return received. It is therefore important that a fund's profits can be distributed in a tax efficient manner.

As a general principle, it is usually the investor who pays taxation on any investment activity, not the investment vehicle. The country in which an investor pays tax will be determined by where they are resident for taxation purposes and the country in which the investment itself is located. As illustrated above, many investors in private equity funds are not based in the country of the fund. They are located in a wide variety of tax jurisdictions. Many are themselves collective investment vehicles, such as pension funds, insurance companies or funds of funds. Taxation will therefore generally be paid by the ultimate investors in those funds wherever they happen to be resident for tax purposes.

Any fund manager will need to consider the tax paid by investors.

What is double taxation?

The investments made by private equity funds are often in companies that are located in a wide variety of countries. The funds are therefore structured to allow the returns to be earned without creating 'double taxation'. Double taxation occurs when a government taxes profits in one country and these profits are taxed a second time (without offset of the initial tax paid) when they are received by the ultimate investor.

Most private equity funds are structured as limited partnerships. These are treated as being 'transparent' for tax purposes; meaning that the partners are taxed, not the partnership itself. Profits made by the fund will be taxed directly on the partners. Dividends or interest received by the fund will be taxed as dividends or interest in the hands of the investors. Gains made by the fund will be taxed on the investors as chargeable gains.

Why are partnerships offshore?

The transparent nature of limited partnerships means the location of the partnership itself should not affect the tax position of the investors. Accordingly, the decision as to whether a partnership is located onshore or offshore will typically be driven by commercial factors, rather than for tax reasons.

Limited partnerships also reduce the level of disclosure as, in certain circumstances, formal accounts do not need to be filed at Companies House. Accordingly, details of the investors in a fund will not appear on public record.

What are non-doms and how are they taxed?

There exists in common law a concept of being domiciled in a particular country. It may be different to a person's nationality or the country in which he or she lives. The concept broadly encompasses the idea of where an individual is 'actually from' and is confusingly

different from either where they are resident, or where they are resident for tax purposes. There are a series of tests that establish whether a person is UK domiciled, relating to where they were born, where they live and the domicile of their parents. A non-domiciled person will pay tax on income and capital gains earned in the UK, but would not, prior to April 2008, be taxed in the UK on other sources of income and capital gains if they were not brought into the UK. Since April 2008, non-domiciled persons generally pay a flat tax (£30,000) after they have been resident for any seven of the previous nine years, or can elect to be taxed as a UK domiciled person.

What is withholding tax?

Withholding tax on dividends, interest and capital gains is often the key tax issue that will impact the returns to an investor. Withholding tax is a prepayment of tax to the government by the fund. It is conceptually equivalent to PAYE taxation of an employees' income, where the employer prepays the employees' tax liability. Withholding tax is used to reduce tax avoidance.

Depending on the residence of the investor, it may be possible to make use of double tax treaties to lower the rate of withholding tax or even reduce the rate to nil.

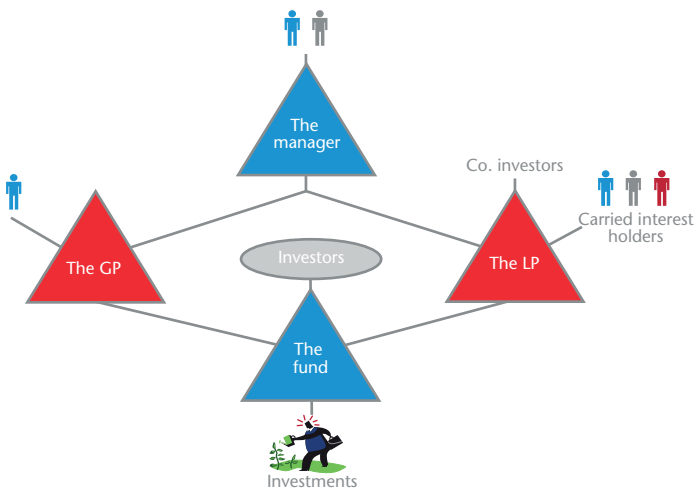
In the UK, an exemption from the obligation to withhold tax on interest exists for Quoted Eurobonds. Debt provided by funds to UK resident portfolio companies can often be listed on an appropriate stock exchange, such as the Channel Island Securities Exchange (CISE), before interest is paid to benefit from this exemption.

The extensive network of double tax treaties that the UK has with other jurisdictions and exemptions such as the Quoted Eurobond exemption make it an attractive jurisdiction for investment. The UK also does not withhold tax on dividends.

2.4.2 Private equity executives/fund

As noted at the start of section 2, fund managers will take a stake in the fund directly, via an interest in the general partner and via a 'carried interest'. They will therefore benefit in the success of a fund and are incentivised to maximise performance (Figure 2.19).

Figure 2.19: Detailed structures in a typical private equity fund



Source: Adam Frais/BDO (UK) LLP.

The general partner will often take the form of another transparent entity, either another limited partnership or a limited liability partnership. Again the partners are taxed and not the partnership which eliminates any double taxation.

However, most of the profits attributable to a general partner will be paid out to the investment manager. It is therefore not unusual to see general partners which are companies.

The taxation of the fund managers will depend upon where they are individually resident and where they earn their income. Income earned in the UK is generally taxable in the UK. Income earned offshore by UK residents is also taxable in the UK. Income earned offshore by non-UK residents is not taxable in the UK.

Why are Scottish partnerships used as carried interest vehicles?

As mentioned above, fund managers will usually have a carried interest vehicle (normally a Scottish limited partnership).

A Scottish limited partnership has a separate legal identity whereas an English limited partnership does not. A Scottish partnership is therefore capable of owning assets in its own name and of being a partner of a limited partnership, such as the main fund vehicle.

How is carried interest taxed?

Profits arising as carried interest are taxed according to the underlying nature of the fund's profits. This was confirmed in 1987 in a memorandum agreed between HMRC and the BVCA, and again in 2003. These memoranda were published by HMRC. This treatment is based upon the principle that the partners invest in the capital of the business and only achieve a gain if the fund increases in value. In many cases, returns on carried interest will be taxed as a capital gain (see Allocation of income and gains). In other cases, some of the carried interest may be received as dividend, fees and interest and taxed as income. These memoranda also confirmed that, providing certain conditions are met, the fund executives will be treated as having paid market value for their carry, meaning they should not be exposed to income tax on the acquisition of carry.

Base cost shift

Initially, a carried interest partnership will have a limited interest in the fund. All profits will be allocated to either the general partner or the investors. However, once the fund has achieved its hurdle rate of return, the carried interest partnership will generally receive an enhanced share of future returns (normally 20% – see section 2.1).

At this time the members of the carried interest partnership will 'acquire' a right to 20% of any proceeds arising to the fund on any future disposal. They will also be deemed to have 20% of the base cost of any assets held by the fund under partnership tax rules (the 'base cost shift'). As the carried interest partners have contributed minimal capital to acquire the assets in the first place, they effectively receive an additional 20% deduction on their share of any gains.

Following the base cost shift, the other investors will have a reduced base cost. Accordingly they will make a larger taxable gain on any subsequent disposal. There are therefore intricate arrangements between the partners to adjust for the base cost shift.

Allocation of income and gains

Most investors in a fund are typically non-taxable entities (pension funds or other corporate entities). They are likely to be indifferent as to the nature of the underlying profits allocated to them.

Fund managers who are individuals investing via a carried interest partnership will, however, be subject to a variety of tax rates dependent on the nature of the allocated profits. At current rates, a higher rate taxpayer will pay UK tax at:

- 45% on interest;
- an effective rate of 30.6% on dividends and;
- 28% on capital gains.

Carried interest is taxed as a capital gain. Accordingly, there is a significant incentive for profits that are allocated to the fund managers to be in the form of capital gains, even before the base cost shift is taken into account.

New anti-avoidance rules on the allocation of profits and losses between members of UK partnerships were introduced as part of the Finance Act 2014. The legislation is broadly seeking to counteract certain perceived abuses of the flexibility partnerships offer.

The new provisions are intended to deal with tax-motivated profit allocations. If there are arrangements in place to manipulate the allocation of profits between members, HMRC is expected to have the power to reallocate the profit to the individual chargeable member for tax purposes.

Do private equity fund managers 'pay less tax than their cleaners'?

In 2007 Nicholas Ferguson, then Chairman of SVG, a quoted fund-of-funds that invests in Permira and other private equity funds, made an oft quoted (and, as it is rarely the same quote, misquoted) remark comparing the tax paid by private equity fund managers and those of 'the cleaning lady'. It was picked up widely in the media that private equity fund managers paid less tax than 'their cleaners' and that therefore there must be something untoward going on. In fact the comment referred not to the amount of tax paid, but the tax rate that was being paid at that time.

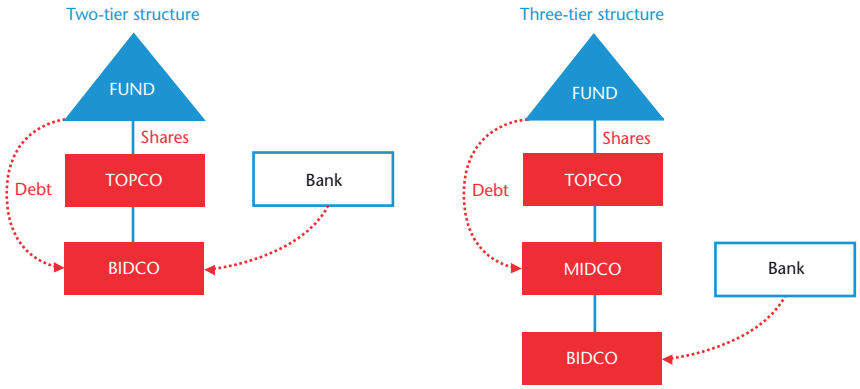
Because private equity funds target capital gains, most of the income is taxed at capital gains tax rates, as described above. Both the way capital gains tax (CGT) is calculated and the rate of CGT were progressively changed and reduced from 2000 onwards. As a result CGT rates fell to below the basic rate of income tax. Therefore, if you assumed that all private equity fund managers earned was capital gains (which is incorrect), they might pay a lower rate of tax than a basic rate tax payer, who might (or might not) include people who clean for a living. They would however, still pay more tax as an absolute amount of money.

The issue was resolved by the introduction of a new higher rate of capital gains tax at 28% for higher rate income tax payers and the various anti-avoidance provisions subsequently introduced.

2.4.3. Investee companies

A new entity, Bidco, will normally be incorporated by the fund to effect the acquisition of a target entity. Bidco will usually be part of a two- or three-tier structure, as shown in Figure 2.20.

Figure 2.20: Different common buy-out structures



Source: Adam Frais/BDO (UK) LLP.

Senior lenders (ie, banks) may wish to ensure that their debt is structurally subordinated (giving them a prior claim to the underlying assets) to that of the investors and therefore a three-tier acquisition may be used with the bank financing being provided to Bidco and the investor debt in Midco.

Tax deductibility of interest

The deductibility of interest arising on any debt in the acquisition structure and the utilisation of those deductions in a tax efficient manner will be the key issue for any company.

The tax deduction for interest on the loan notes and other debt issued by a portfolio entity is restricted to the amount of interest that corresponds to arm's-length terms (ie, those equivalent to an unconnected, non-shareholder, lender).

Any restriction of the interest deduction arising on the debt provided by the fund can affect the way interest received is taxed on the investors who are UK tax resident.

Abolition of 'tax free' income

In the past, where interest was not deductible against corporation tax, a UK resident investor might receive that interest tax free. The argument was that the interest had in effect already been taxed, because it had not been deducted from profits, so it should not be taxed again when received by the investors. These rules were perceived to allow interest to be paid to UK investors free of tax. The rules changed with effect from October 2013 to stop this. The new rules largely bring the UK into line with other jurisdictions. As a result, the interest is now treated as a dividend when received by individual UK investors. UK corporate investors will continue to benefit from a corresponding adjustment.

Accrued versus paid interest timing differences

Interest can be deducted either when it is actually paid in cash, or when it is charged to the company's accounts ie, when it is accrued. Generally, tax deductions for interest on shareholder debt will only be allowed on a paid basis. However, it can be allowed when it is paid within 12 months of the end of the period in which it accrued. This 12-month window creates limited opportunities to time interest payments to ensure that tax deduction can be utilised in full. It avoids tax relief becoming 'stranded' in the company.

The 'paid basis' was originally introduced as an anti-avoidance measure. It was to deny claims for tax deductions on interest that might not actually be paid until sometime in the future. At the time of writing, these rules were under review by HMRC.

There are other provisions that can restrict the tax deductions available for interest. These include the worldwide debt cap and other measures that can reclassify interest as a non-deductible distribution. These other measures generally apply where there is a particular tax avoidance motive or purpose for the debt or where the debt exhibits similar characteristics to equity (eg, the rate of interest varies based on performance of the company).

Findings 2.7: What are the effects of taxation on private equity? The academic evidence

Using debt rather than equity to fund a business may reduce the corporation tax bill of any company because some interest is deducted from profits before tax is calculated, whereas dividends are not. Since 2005 the rules in the UK (and elsewhere) have been tightened so that if debt is provided by a shareholder on a 'non-arm's-length basis' then the interest is not allowed to be deducted against corporation tax. In LBOs, a great deal of effort is applied to creating a structure that is tax efficient. This is generally the case for almost any company, but comes into sharp relief when a company changes the way that it is funded, as in a buy-out. It has been argued that the returns earned by leveraged buy-outs can be explained by the effect of interest payments on corporation tax and there is extensive academic research investigating this hypothesis. Early studies in the US showed some support for the argument, but since these studies were completed there have been many changes in the taxation of leveraged buy-outs in many countries, including the UK (Appendix Table 4). At the time of writing, the most recent studies around the world have found no evidence to suggest that taxation is an adequate explanation for the performance gains seen in successful buy-outs.

2.5 Refinancing and exits

2.5.1 Types of exit

All private equity transactions are structured with an exit in mind. Historically there were three exit routes:

- trade sale: sale of the business to a corporate acquirer;
- flotation on a stock market;
- receivership and liquidation.

This publication does not explain these types of exit as they are well understood. However, new routes to exit include:

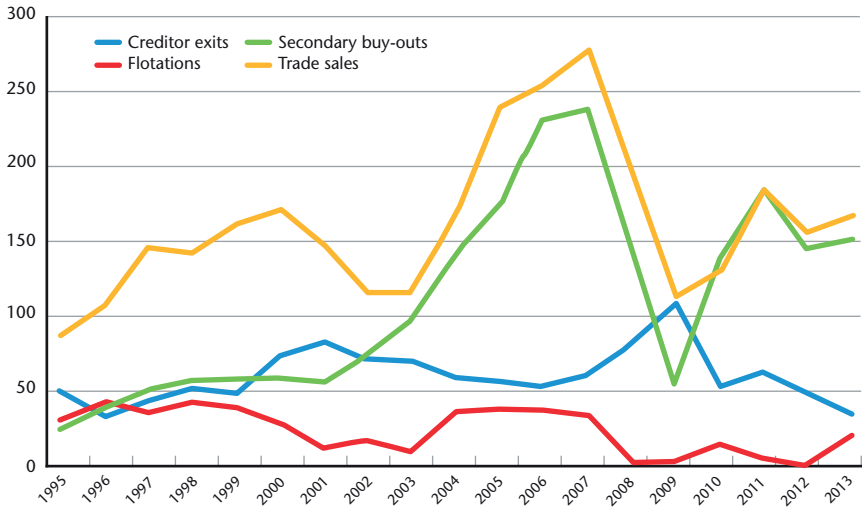
- secondary buy-out/sale to another private equity fund;
- leveraged recapitalisation/repayment of loans and preference shares; and
- secondary market transactions including the sale of portfolios of investments to other financial institutions.

These are discussed in more detail below.

Not all exits crystallise increases in value; some investments are written off or down.

2.5.2 What has been the pattern of exits from private equity deals?

Figure 2.21: European divestment numbers by type of exit



Source: CMBOR/EY/Equistone Partners Europe.

As shown above in Figure 2.21 the period from 1995 to 2013 in Europe have been marked by a general decline in the number of private equity deals that float on a stock market (IPO). However, there has been a notable growth in the number of large secondary buy-outs, providing liquidity for the buy-out market at a time when alternative exit routes have been difficult. These deals may lead to the prolongation of disintermediation from public markets, but may maintain the positive benefits of private equity governance and incentives as a longer-term organisational form. Such transactions raise important and challenging unresolved issues relating to performance evaluation. In particular, if the original private equity financiers were effective, how likely is it that further performance gains can be achieved? Increasing evidence is becoming available on the performance of secondary buy-outs, with the balance of evidence indicating that returns are below those for primary buy-outs (see below).

2.5.3 Secondary buy-outs and new principal agent issues

In the early years of the buy-out market it was rare for a private equity fund to be prepared to buy a business from another private equity fund. Up to 2007 it was common, accounting for about a third of larger buy-out exits (Figures 2.22 and 2.23). Despite a fall in secondary buy-outs in the dislocation that followed the banking crisis, the numbers of secondary deals have been rising and 25%–30% of all buy-outs are now transactions between private equity houses. There has also been a convergence in the value of primary and secondary deals. In 2013, the value of secondary deals completed in Europe exceeded that for primary deals, for the first time. This has raised a number of issues regarding 'churn' in the private equity market.

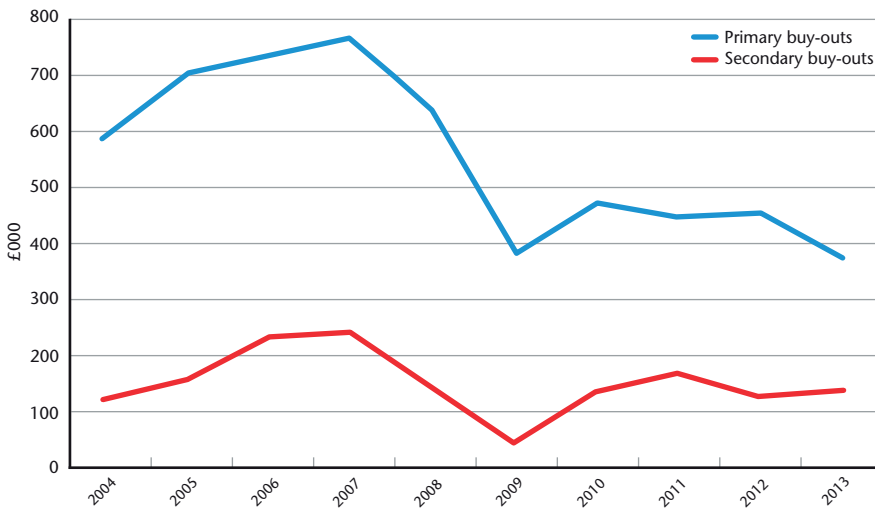
Where a fund is approaching the end of its agreed life and has yet to exit an investment, a fund manager may face an unusual set of incentives. If the fund is extended to maximise the value of the last investment(s) there are penalties for the fund manager. Therefore, it may be more rewarding to the manager to sell the asset for whatever value can be achieved today, rather than attempt to maximise the value in the longer run. In this sense there is an apparent anomaly in private equity fund structures: the longer an investment has been held in a fund, the more likely it is that the private equity fund manager is incentivised to act based on short-term considerations.

In recent years, the most liquid acquirers of corporate assets have been private equity funds. Therefore, a fund seeking a quick exit will very probably approach, among others, private equity funds. One way to mitigate the potential forgoing of value in such a transaction might be for the vendor private equity fund managers to co-invest in the business alongside the new private equity fund and do this from another fund under their management. This could trigger the carry in the old fund and carry forward the asset in the new fund at the value established by a third-party purchaser.

Furthermore, funds that are underinvested and are approaching the end of the investment period have strong incentives to invest or lose access to the committed capital. Recent research suggests that secondary acquisitions late in the life of a fund have lower returns than would be normally expected.

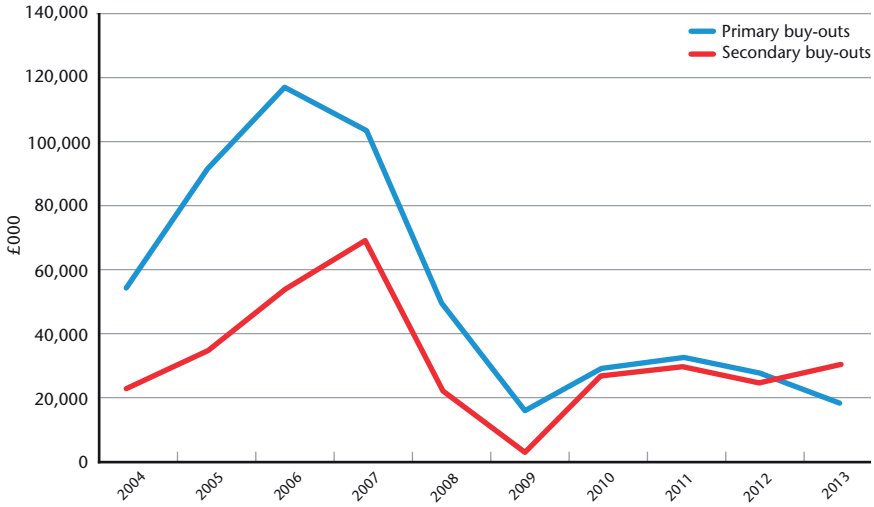
As the market has evolved, investors in private equity funds have had to be careful to ensure that the incentives of the fund manager and the investors in each and every fund are tightly aligned. Ultimately the constraint on fund managers is reputational: in the long run, investors will not support fund managers that abuse their relationships.

Figure 2.22: European primary and secondary buy-outs by number



Source: CMBOR/EY/Equistone Partner Europe.

Figure 2.23: European primary and secondary buy-outs by value



Source: CMBOR/EY/Equistone Partner Europe.

Findings 2.8: What are the drivers and impact of secondary buy-outs? The academic evidence

US evidence indicates that firms are more likely to exit through secondary buy-outs when the equity market is 'cold', the debt market condition is favourable, and the sellers face a high demand for liquidity, with the last being the strongest reason (Appendix Table 13). Secondary buy-outs appear to be priced higher than first-time buy-outs due to favourable debt market conditions. Performance declines in the primary buy-out before a secondary buy-out takes place and primary buy-outs exiting as a secondary buy-out generate lower internal rates of return on average than other forms of exit. The longer a firm has been held in the portfolio of the private equity firm, the more likely it is to exit as a secondary buy-out. The systematic studies now emerging show evidence on average of a deterioration in long-run returns following secondary buy-outs. UK evidence shows that secondary buy-outs on average perform worse than primary buy-outs in terms of profitability, productivity levels and growth, sales growth and internal rate of return. Secondary buy-outs also have lower efficiency than buy-outs of private firms or divisional buy-outs. The positive effects of secondary buy-outs on firms' operating cash flows seem to be achieved through expansions, not by running the firms more efficiently. However, secondary buy-outs between specialised private equity firms perform better than those conducted between other private equity firms.

2.5.4 What is a leveraged recapitalisation?

As with secondary buy-outs, the market in leveraged recapitalisations (or 'recaps') has become more active in recent years. A recap involves the investee company re-borrowing debt previously repaid and/or increasing borrowings (usually due to increased performance since the original buy-out) from the wider banking industry. These new borrowings are used to repay and/or restructure the loan elements of the original financing structure, sometimes including the private equity investment in loan stock and/or preference shares (and sometimes paying a dividend).

The return will generally take the form of a repayment of loan stock and a dividend. The capital repayment can be tax free (as there is no profit or loss) and an individual receiving the dividend currently pays tax at 25%.

There is little academic research regarding the effect of recaps on investment performance. Recaps arise for one, or a combination, of three reasons:

1. re-borrowing debt that has previously been repaid;
2. increasing the amount of debt because the performance of the business has improved; and
3. increasing the amount of debt because the banks are prepared to lend more debt at the same performance level.

During the credit boom the appetite of banks to lend was exceptionally high. This resulted in a sharp increase in leveraged recaps.

To the extent that a business is able to replace more expensive capital with less expensive senior debt, these transactions can be seen as enhancing efficiency. The corollary is that financial risk to the business increases with the level of senior debt.

The impact on a fund's performance is to accelerate cash returned from any investment, thus increasing the IRR of the fund. However, this increase comes at the cost of reinstating or increasing financial risk in the portfolio.

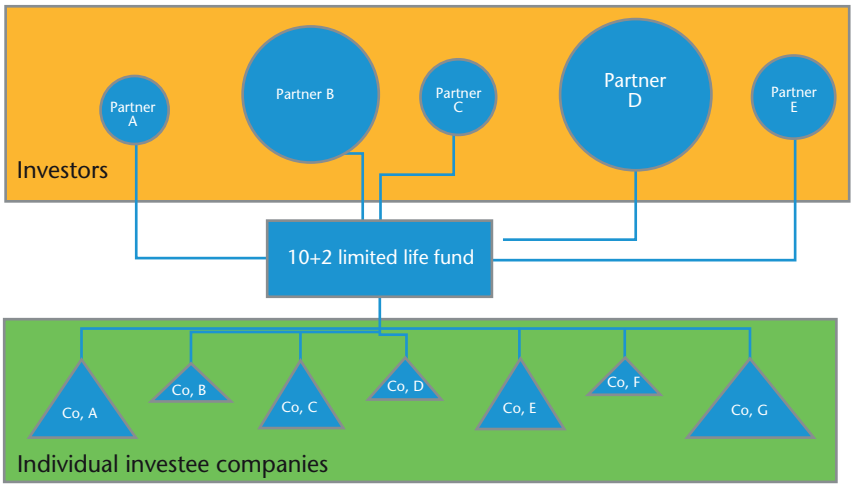
The maximum amount that can be repaid without a capital profit being created will generally be the amount of the investment at cost (plus any PIK interest – see section 4). To the extent that there is greater borrowing capacity a dividend may be paid. This dividend will be equal to the excess of new borrowings over the cost of the investment. This raises complex tax issues as the dividend will be received as income, not capital gain.

There is therefore a series of trade-offs to be calculated: how much borrowing is it prudent to have? What is the impact on fund returns and risks? What is the tax implication of receiving dividends rather than capital proceeds or gains? Finally management's position requires consideration. To the extent that they receive no benefit from a recap, management's risk is increased with no reward. This needs careful and considered negotiation before any deal is structured.

2.5.5 What is a secondary fund market transaction and how does it differ from a secondary buy-out?

We referred earlier to secondary fund market transactions. We have not discussed this class of transaction in any detail in earlier editions. The name is confusingly close to that of a secondary buy-out, and covers two distinctly different transaction types, both of which are fundamentally different to a secondary buy-out.

Figure 2.24: Typical simplified fund structure to illustrate different secondary transactions



Source: Gilligan and Wright.

In a secondary (or tertiary, or whatever) buy-out, as we described earlier, the investment is sold to a new company that happens to be funded by a private equity fund. In essence the sale is legally identical to a trade sale although the financial terms are usually more complex and require some degree of skilled design. In the diagram above, this is the sale of company A, B, C through to G to another private equity fund.

In a pure secondary fund market transaction, it is not the whole company that is being sold. Rather, it is the interest in the shares and loans of all the companies owned by a particular LP who is invested in the fund (and any further undrawn commitments) that is sold to a new LP. The new LP will take their place in the investing partnership. In the diagram above it is the interests of partner A, B, C etc, in the fund that is sold.

Essentially the fund is allowing one of its partners to leave the partnership, as long as it can find a buyer for its existing interests who will fund its ongoing future commitments. This is therefore a sale of a portfolio of investments, not the sale of a single company. The portfolio may also include a commitment to make further investments in the future.

When the fund is a captive of an insurance company, bank or similar institution, the process is more straightforward. The parent company simply markets and sells the portfolio of assets it wishes to dispose of, usually along with a new management contract that typically specifies that the team that made the investments manages them under a new set of terms. In the diagram it is the creation and sale of the whole fund that is subject to the transaction.

How is a secondary fund market transaction completed?

The earliest secondary fund market transactions were small and involved the consensual change of partners within particular funds. This might arise due to a change in the investment appetite or ability of a particular LP leading them to request that a GP allowed them to find a replacement investor. The new investor is not allowed to

renegotiate the terms of the partnership and therefore the question of pricing becomes one of 'what price shall I pay for the existing investments, given that I am taking on a commitment to fund the selling parties' future liabilities?' The language used around secondary transactions therefore reflects a discount or premium to the current value of the selling LP's interest.

The process will involve the preparation of a sellers memorandum explaining:

- the current investments made by the fund and their current estimated value;
- the undrawn commitments that a new LP will potentially be required to fund; and
- the terms of the partnership that the new LP will become party to.

Interested parties will submit an offer based on all this information. If they perceive that there is value over and above the current estimated value, they may offer at a premium to net asset value (NAV).

Recall that in section 1 we talked about how due diligence is done on the manager by potential LPs and by the GP on the financial worth of the potential LP. The investor wants to understand the track record and prospects of the potential manager of its money. Conversely the GP/manager wants to ensure that the potential funder can meet their obligations to the fund over the next 10 years or more. When an LP wants to change, subject to the details of each partnership agreement, the process is very similar. The fund manager/GP will only allow a change if the buyer is of acceptable standing. Where funds are seriously underperforming it is not unusual for there to be enhanced rights for investors to try and find a replacement investor on the same terms.

What impact does the secondary fund market market have on incentives?

Earlier we talked about the alignment created by the long-term relationship between all the investors in the private equity partnership. We argued that in this sense, private equity is a very long-term, illiquid investment vehicle. The secondary fund market weakens all those relationships by allowing membership of investment partnerships to evolve and change over time. This allows investors to come in to private equity after investments have largely been made, but before they have been exited, eliminating so-called 'blind risk' (the risk of not knowing what the fund's assets will be). Conversely investors who prefer the risks and rewards associated with a new fund with no investments can realise their investments independently of the fund manager's ultimate decision to sell any particular company.

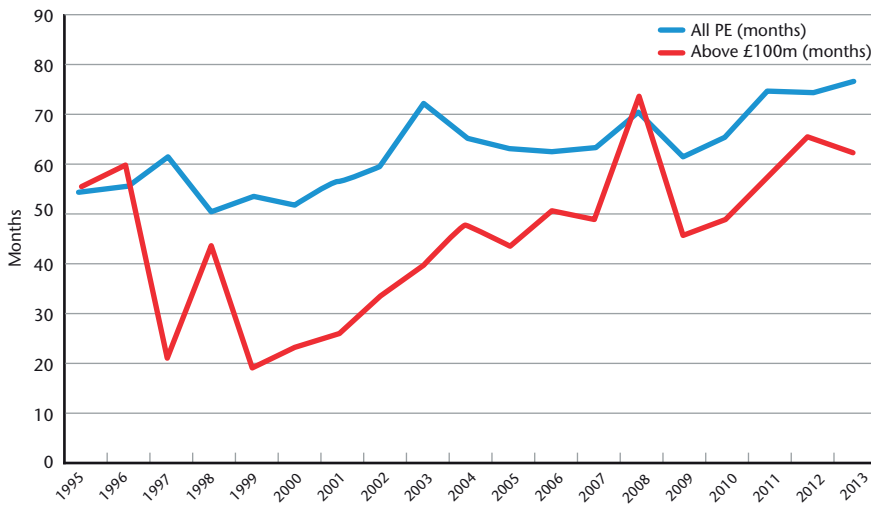
It has been hugely important in the post-crash environment for LPs to be able to trade their fund positions. Investors have found that they have had to change their asset allocations for a host of regulatory and financial reasons. Large secondary firms have emerged able to acquire multi-billion dollar portfolios and positions in private equity funds.

Had these secondary fund markets not been created it is likely that limited partners who had commitments that they could not meet to private equity funds, may have defaulted and a crisis in confidence in the private equity model ensued.

Findings 2.9: Do private equity deals involve the short-term 'flipping' of assets? The academic evidence

When we return to the question of short-termism, it is at the company level that we need to focus the analysis. The academic evidence (Appendix Table 5) suggests that there is a wide variation in the length of time any investment is held. There is no evidence that the industry systematically seeks to 'flip' investments in a short time period. Evidence from the 1980s in both the US and UK shows that some buy-outs are exited in a relatively short period of time, while others remain with the buy-out structure for periods in excess of five years. On average, larger deals exit significantly sooner than small deals. During the second private equity wave, there were very short periods to exit of some private equity deals, but this is neither new nor surprising and most are held in portfolios much longer. Some deals fail soon after completion while others may be turned around quite quickly and receive unsolicited bids by trade buyers. Over time, the average time to exit is increasing (Figure 2.25), the most common timing of exit for those deals that have exited since 2000 is in the range of 5–6 years.

Figure 2.25: Average time to exit in private equity-backed buy-outs by year of exit in the UK



Source: CMBOR/EY/Equistone Partners Europe.

Findings 2.10: What is the extent of asset sales and refinancing? The academic evidence

US evidence from the 1980s suggests that larger buy-outs involving P2Ps engage in substantial divestment of assets (Appendix Table 6) to an extent significantly greater than for buy-outs of divisions. The extent of asset sales among UK buy-outs completed in the 1980s was much less than in the US. It should be noted that buy-outs divesting assets may also have been making acquisitions. Partial sales peaked in Europe at 163 in 2005 and at 12 billion in 2006, but then fell sharply from 2008 until recovery in value in 2012. In 2013 there were only 65 partial sales for a total value of €9.3 billion. European refinancings also peaked in the boom years of 2005–2007 at around 130 per year, with a high of €46.5 billion in 2007. Numbers then fell to below 100 per year before recovering sharply in 2013 at 125 for a total value of €41.6 billion.

Findings 2.11: Do the effects of private equity continue after exit? The academic evidence

An important unresolved question is whether the claimed benefits of private equity deals are sustained once the buy-out structure ends (Appendix Table 7). US evidence is that while leverage and management equity fall when buy-outs return to market (reverse buy-outs), they remain high relative to comparable listed corporations that have not undergone a buy-out. Pre-IPO, the accounting performance of buy-outs is significantly higher than the median for the respective sectors. Following the IPO, accounting and share price performance are above the firms' sector and stock market benchmarks for 3–5 years, but decline during this period. This change is positively related to changes in insider ownership but not to leverage. Those private equity-backed MBOs in the UK that do IPO tend to do so earlier than their non-private equity-backed counterparts. There is some evidence that they are more under-priced than MBOs without private equity backing, but not that they perform better than their non-private equity-backed counterparts in the long run. Private to public MBOs backed by more active private equity firms in the UK tend to exit earlier and these MBOs performed better than those backed by less active private equity firms. However, IPOs of private equity-backed buy-outs have been rare if not absent altogether in recent years although they did make something of a recovery in 2013.

2.6. How did the UK private equity industry respond to public scrutiny?

In 2007, at the request of the BVCA, a committee was established to review disclosure by private equity firms and companies controlled by private equity firms. The Walker Guidelines were published in 2007 and the Guidelines Monitoring Group was established to report annually on compliance with the guidelines.

2.6.1 What are the Walker Guidelines?

The Walker Guidelines (the Guidelines) were first published in 2007 with the intention to bring greater transparency to the private equity industry's largest investments and investors. The Guidelines are a voluntary code of practice. They are monitored by the Guidelines Monitoring Group consisting of a chairman, two independent representatives from industry and/or the trade unions and two representatives from the private equity industry.

From the end of 2010, adjustments to the criteria were introduced. They now apply to portfolio (investee companies):

- with an enterprise value of £350m at acquisition (previously £500m) or £210m in the case of companies that were quoted prior to acquisition (previously £300m); and
- have 50% or more of their business in the UK; and
- employ over 1,000 people in the UK.

Any private equity firm that has invested in a business covered by the Guidelines is then required to make disclosures about itself. This represents a relatively small proportion, by number, of the total population of companies that have been invested in by the private equity industry but accounts for a significant proportion of the total amount invested by private equity firms (Table 2.5).

Table 2.5: Private equity and portfolio firm compliance with the Walker Guidelines

	2008	2009	2010	2011	2012	2013
Portfolio companies required to conform	27	45	43	78	73	72
Portfolio companies voluntarily conforming	27	15	12	9	7	17
Total number of portfolio companies covered by the code	54	60	55	87	80	89
Total number of private equity companies covered by the code	32	34	35	43	47	53

Source: Guidelines Monitoring Group.

The Guidelines broadly require that companies provide the same kind of information to the public that would be provided if the companies were publicly traded.

The new element has been the requirement to communicate more broadly with any and all interested parties. The information required is included in an annual review published on the private equity fund's website. It is not required to (and generally does not) contain accounting or investment performance data. It seeks to identify who the individuals are within the private equity fund and what investments they hold. Limited information on intended investment duration and limited partner type (but not identity) is also given. The Monitoring Group issued a guide providing practical assistance to companies to help improve levels of transparency and disclosure, and which included examples of portfolio company reporting reviewed by the Group.

Further data provision to the BVCA for their annual report is also required that does include high-level financial data including the amount of capital raised, number and value of investments made and fees paid to advisers. Data that analyses the source of investment performance in exited investments is also sought to enable the annual review to be completed.

At the time they were introduced, there was some scepticism about the likely extent of compliance with the Guidelines. in the event, compliance is high and on an increasing trend. The sixth report published in 2013 noted a continued increase in the level of overall compliance, with the overall failure rate for providing enhanced disclosures decreasing to 3% for portfolio companies reviewed in 2013 from 13% in 2012. The sixth report also noted that the increase in the number of portfolio companies covered since the previous year was due to the inclusion of additional companies outside the scope of the Guidelines complying voluntarily. However, there was variability in the quality of disclosures and fewer examples of excellent disclosure, in part due to enhanced standards seen in the FTSE 350. Not all portfolio companies make the audited report and accounts available on their website, while the Monitoring Group emphasises that accounts should be readily accessible on the company's website. The quality of disclosures in respect of trends and factors likely to affect future development, performance or the position of the company's business was varied, in many cases the information was historical and discussion lacked a forward-looking orientation. All BVCA members were committed to complying with the Guidelines but only two out of 22 non-BVCA members did so. The Monitoring Group continues to enhance the provisions of the Guidelines to ensure that all companies covered report to a level comparable to current good practice in the FTSE 350.

2.7 What is the Alternative Investment Fund Managers (AIFM) Directive and what are its implications for private equity?

The AIFM Directive was passed by the European Parliament in November 2010. The Directive comes into force in stages from 2013 and 2014.

Who is exempt? The Directive applies to alternative investment fund managers (AIFM) who are based in the EU, market funds or invest in the EU. The Directive therefore in principle applies to most private equity fund managers. There are, however, exceptions based on size and fund structure that favour private equity. If funds do not offer investors liquidity and have no internal gearing, a fund manager is exempt where the total funds under management fall below a threshold of £500m. If investors can redeem their investments the threshold is £100m. This exemption was negotiated to recognise the long-term nature of private equity funds.

Funds falling under the Directive are restricted as to whom they may market their funds. The apparent intention is to protect unsophisticated investors from complex and risky funds. The UK resisted the imposition of trans-EU regulation and the marketing aspects of the Directive are now being phased in over 10 years.

Initial proposals designed to stop asset stripping would have prevented leveraged buy-outs where the loan was secured on the assets of the target company. Essentially this would have taken us back to where we were prior to the Companies Act 1981. The measures would effectively have removed the business model used in leveraged buy-outs. The measures included in the Directive have been significantly diluted from these original proposals.

The Directive contains provisions to limit the levels of leverage that can be used by AIFM within funds. Leverage at the portfolio or holding company level used by private equity firms is not included in the definition of leverage used throughout the Directive. As private equity transactions use debt at the portfolio company level not the fund level this restriction has limited effect on private equity.

There are requirements for AIFM to have minimum capital related to the size of the underlying funds. Some consider that these requirements are misguided where the funds are inherently illiquid, as in most private equity funds.

The Directive requires AIFM to introduce a remuneration policy consistent with, and which promotes, sound and effective risk management. An AIFM must prepare an annual report for each EU alternative investment fund (AIF) it manages or non-EU AIF it markets in the EU. The report must be provided to the relevant EU competent authorities, as well as to investors on request.

An AIFM must notify its voting rights to its relevant regulator when it acquires voting rights of 10/20/30/50/75% of a non-listed company. When an AIFM acquires voting rights of greater than 50% in a non-listed company, additional disclosures must be made to its regulator, the company and its shareholders.

The private equity firm needs to disclose to regulators the chain of decision making regarding the voting rights of investors in the company; and practices to be put in place to communicate to employees. In changes to the original draft, there is no longer a need to disclose detailed information on the private equity firm's strategic plans for the company. Companies with fewer than 250 employees are excluded from these disclosure requirements.

AIFM are required to maintain an external depositary to safeguard the assets of the fund. Private equity received a specific derogation providing that national regulators may authorise non-investment bank entities to act as the depositary for private equity and venture capital funds, thus reflecting the circumstances of the industry.

Overall the Directive is complex and represents a significant increase in regulatory disclosures and regulatory burden, but does not materially impede any private equity fund manager from continuing their business.