CHAPTER 1

Introduction to Private Equity

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INTRODUCTION

Private equity (PE), including buyout and venture capital (VC) transactions, is a critical component of modern finance. Since 1980, over $1.1 trillion has been raised by U.S. buyout funds and roughly $700 billion has been raised by VC funds. (See Exhibit 1.1 and Chapter 2 for additional information on fundraising trends.) Eight hundred thirty billion dollars was raised by U.S. buyout funds in the last 10 years alone, while $489 billion was raised by U.S. VC funds over the same time period.

While relatively small levels of PE capital were raised through the early 1980s, PE fundraising levels have experienced considerable growth—and

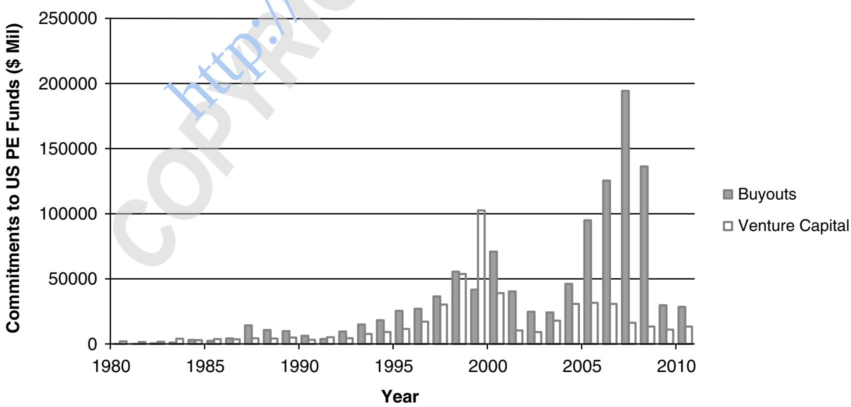

EXHIBIT 1.1 Historical Venture Capital and Buyout Annual Fundraising Levels, 1980–2010
Source: Thomson's VentureXpert database.

cyclicality—since that time. However, in spite of the large amounts of capital placed in PE, relatively few individuals have even modest knowledge of this central pillar of the contemporary financial system.

This chapter introduces PE, defines frequently used PE terms, provides an overview of the PE model, and describes the PE fundraising and investment processes. It is not comprehensive in nature but, instead, presents an introduction to numerous concepts that are discussed in greater detail in later sections of this book. Newly defined terms are italicized for the reader's convenience.

For comparative purposes, data within this text is generally examined on an annual basis; the latest period of data available prior to this book's publication was the year ending December 31, 2010.

Though many forms of PE exist, this book will largely focus on two types of such investments: buyouts and VC. Other types of PE investments, including mezzanine financing, private investments in public equity (PIPEs), and fund of funds (FoF) investments, will be discussed throughout the work; however, these will not be the primary focus of this text.

WHAT IS PRIVATE EQUITY?

Many definitions of PE exist, though, at the simplest level, PE is a medium or long-term equity investment that is not publicly traded on an exchange. PE includes VC and buyout transactions as well as investments in hedge funds, FoF, PIPEs, distressed debt funds, and other securities. It also includes angel financing or investments in very early stage companies. The focus of this text is VC and buyout transactions, and the funds originating such transactions as these funds manage a majority of PE capital.

The previous definition of PE generally holds, though exceptions exist. PE includes transactions structured with convertible debt; the purchase of publicly traded companies that are subsequently taken private and delisted from an exchange; and illiquid investments in publicly traded companies. However, while a business itself may be publicly traded, a PE fund's investment in such a business is generally not traded.

In the United States, PE investments are themselves not traded on the New York Stock Exchange (NYSE), NASDAQ, or other regional exchanges, though some PE firms, including The Blackstone Group (Blackstone) and Kravis, Roberts & Company (KKR), have gone public in recent years. Without an exchange on which to trade shares, and in the absence of market makers, PE investments are generally illiquid and held for between three and seven years before a liquidity event or harvest occurs. At this time, the PE fund is able to realize gains (or losses) from the sale of the company.

There exist two categories of PE investment: capital placed in funds (*fund investing*) and capital placed in *portfolio companies* (*direct investing*), or companies under direct ownership of an entity. For example, a pension fund rarely invests capital directly in portfolio companies, though some exceptions do exist. Pension fund managers and their staff instead generally focus their efforts on fund investing activities: they place capital with PE funds that act as appointed managers between the pension fund and portfolio company. PE funds, conversely, use their capital to make direct investments in portfolio companies.

GENERAL TERMS AND BRIEF OVERVIEW

To understand the PE arena is to understand the "man behind the curtain" in *The Wizard of Oz*—many details of the industry are shrouded in secrecy, and firms are often reluctant to divulge details of their funds to outsiders. Nonetheless, once understood, the complexities of the industry largely vanish, and the reader is left with a concrete understanding of the motivations that keep such a well-oiled machine running. The privacy in which the industry operates is essential to its function. Many of the PE transactions involve providing liquidity to family and privately held companies not at all interested in publicity. In the VC segment, many of the investees are technology based and careful guarding of private and proprietary business intelligence and intellectual property is essential until such investees reach critical mass and can lead or sustain novel market positions.

PE funds are usually organized as limited partnerships and are formed and managed by management companies, formed by the GPs of each limited partnership. These funds are—for the most part—private investment vehicles that permit investors to pool their capital for investment in portfolio companies, allowing investors to greatly increase their diversification, reach, and purchasing power in the marketplace. A PE firm may offer investors the opportunity to invest in multiple funds.

The limited partnership or limited liability company (LLC) structure affords PE funds a number of advantages, including the use of pass-through taxation. In other words, the income generated from such an organization is taxed only once, as it flows to the partners. This is in contrast to a C corporation, where a corporation must first pay corporate-level taxes on income, in addition to taxes paid by owners as ordinary or dividend income. PE funds, also frequently organized in such a manner as these types of organizations, have a finite lifetime.

As of the date of this writing, PE funds are frequently unregistered investment vehicles, meaning that, unlike publicly traded securities, their investment and financial reporting policies are not governed by the Securities and Exchange Commission (SEC) or another policing body. Regulation of the PE industry is an evolutionary process, and significant changes will soon affect larger PE funds. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) of 2010, many PE funds will be required to register with the SEC. Exemptions to registration requirements exist for VC funds, funds with under $150 million in assets under management, and foreign funds without a place of business in the United States.[1]

Managers of PE funds are often referred to as the *general partners* (GPs), while investors are known as the *limited partners* (LPs), the latter term signifying the limited liability of the investors: investors can lose, at most, the sum of their total committed capital contributions.

Capital for PE investments comes from a variety of LPs. Corporations, banks, and insurance companies were early investors in PE. More recently, pension funds, foundations, and university endowments have joined other LPs to place significant portions of capital with PE funds. These relative newcomers began flocking to PE in the late 1970s and early 1980s due to high historical returns and changes to investment regulations, and growing experience with the benefits of PE funds.

The California Public Employees' Retirement System (CalPERS) and Blackstone are prominent examples of limited and general partners, respectively. CalPERS manages nearly $240 billion of capital; $24 billion is committed to PE funds. CalPERS' portfolio includes investments in numerous buyout and VC funds, including those run by Apollo Management; Blackstone; The Carlyle Group; Kohlberg, KKR; Madison Dearborn Partners; TPG Capital; Khosla Ventures; and Alta Partners. Furthermore, as is often the case in PE, CalPERS has a close relationship with many of its PE fund managers. The organization has participated in at least three funds managed by each of the above-mentioned PE firms.[2]

PE fund investments in portfolio companies are made at the discretion of the GPs, to whom investors entrust their capital. LPs do not influence the day-to-day operations of the fund, as doing so may cause them to lose their limited liability status. Some LPs, having seen net returns diminish with the economic crisis, are demanding greater transparency in fund operations. LPs receive quarterly statements and reports from PE funds relating portfolio companies receiving investment, capital deployed to date, and investment returns, among other items. LPs may express their sentiments regarding these items, but they are not involved in day-to-day fund-level decisions. PE funds have annual meetings to account to LPs, and operate with advisory committees, which include LPs as members.

Unlike other investment vehicles, most PE funds are limited-life entities. They do not exist in perpetuity, and they have a legally bound, limited

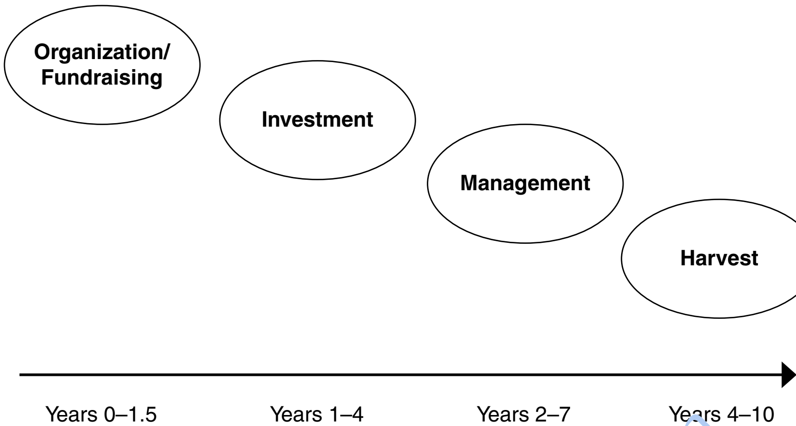

EXHIBIT 1.2 Typical Stages of a Private Equity Fund

lifetime; conversely, *evergreen funds*, as their name implies, are not limited-life entities. While a firm may exist for decades, the typical lifetime of a given PE fund is roughly 8 to 12 years, the average being 10 years. However, in some cases where prospective fund deals may already be scouted, a fund life of six years is not uncommon.

Throughout a fund's lifetime, it will typically go through four stages: organization/fundraising, investment, management, and harvest. See Exhibit 1.2 for further information.

During the organization/fundraising phase, a PE fund recruits investors and determines its strategy and investment focus. The latter point is especially important for VC funds, as they often target a specific area of the marketplace for investment. A fund's focus generally includes the industry, stage, and geography of companies in which it will invest. At least two of these three parameters are frequently held constant and may not be compromised in the investing process. For example, a VC fund may specifically focus on early-stage medical devices across the United States; generally this focus would not change without concurrence of a majority of LPs.

The fundraising phase is highly challenging, especially in times of economic turmoil. Unlike other types of entities, PE funds cannot place fundraising advertisements in newspapers, journals, or online sources, issue press releases, or grant interviews to the press in order to promote their funds, largely because they are not permitted to do so (fund regulations are discussed later in this section). Instead, fund promotion is generally accomplished through word of mouth among LPs, most of whom have a large network of peers. *Placement agents* may also be used by GPs to reach qualified investors.

In a typical, 10-year, limited-life fund, the organization/fundraising stage generally occurs over the first 18 months of the fund's life. The fundraising pace is dependent on numerous factors, including the overall macroeconomic environment and investors' appetite for PE. Some of PE's largest mega funds raised money at even faster levels throughout 2006, 2007, and the first quarter of 2008; fundraising since that time has taken considerably longer for most funds.

It is a primary goal of the PE firm to cultivate long-term relationships with its investors and *gatekeepers*, the latter denoting organizations that assist investors in allocating their PE capital. Gatekeepers are usually compensated with a 1 percent annual fee on committed capital. These agencies are used by LPs to locate PE partnerships that match their investment criteria. Investors with little previous experience in PE investment will often use gatekeepers, as will those with limited staff resources, as gatekeepers frequently provide ancillary services such as due diligence for their clients. Many gatekeepers today also act as FoF managers. An FoF is a partnership that invests capital in multiple PE funds. Because they cultivate long-term relationships with PE fund managers, an FoF manager may be able to access a PE fund not possible directly.

Once the organization/fundraising phase has been completed, the investment stage begins. During the investment stage, GPs scout deals and develop deal flow for their fund. This stage typically encompasses years one through four of the fund. While LPs make funding commitments to the GPs when they first join the fund, only a portion of their pledged capital is immediately taken at the fund's *closing*, or date at which fundraising concludes, nor invested. Once a closing has occurred (typically 12 to 18 months after the fundraising process begins), GPs require time to scout deals before they begin investing money. GPs usually time formal requests to LPs for pledged capital with the projected closing of actual investments. These requests are termed *capital calls*. Once a capital call has been executed, the funds from the capital call are invested in portfolio companies.

Though our previous example highlights *event-based capital calls*, other types of capital calls exist. For example, some funds draw down capital from investors on a prespecified time schedule. This permits the investor to budget for capital subscriptions with certainty.

Waiting to *draw down* capital from LPs, as opposed to demanding all capital up front, allows a GP to maximize the internal rate of return (IRR) of its investments. IRR is a function of the cash-on-cash return received as well as the amount of time required to generate such a return. By drawing down capital from LPs as it is needed, a GP is able to minimize the time element of the IRR calculation, boosting fund returns and the PE firm's reputation. The LP requires this so that it can retain its committed capital in its own investing cycle until called.

Beginning in approximately year two, a PE fund will focus on managing investments in portfolio companies. In some cases, GPs will replace the management team of such a company with professionals from inside the firm while, in other cases, the company's management team may remain in place. Throughout this time period, PE investors may also attract other funds to assist them in raising capital to take the firm to the next level. Such an investment, where multiple firms purchase equity stakes, is called a *club deal* or *syndicated investment*.

Syndicating investments allows GPs to:

- Form relationships with their counterparts.
- Ensure a portfolio company has enough *dry powder* or reserve capital to become successful.
- Diversify risk.
- Provide potential exit opportunities for an initial investor.

Though it may seem counterintuitive to form relationships with competitors, GPs benefit from such relationships by obtaining access to deals in which they might not otherwise participate and bring additional intelligence to benefit the investors. In exchange for this favor, it is expected that the GP who received access will reciprocate on his next deal. Syndication also broadens the base of investment, allowing the portfolio company to tap numerous sources of capital and permitting GPs to hedge investment risks through partnerships with syndicate investors. Lastly, syndication provides potential exit opportunities for GPs, as a GP may sell his interest in the portfolio company to another investor when the GP's fund enters its harvest phase.

In years 4 through 10, known as the *harvest* or *disinvestment period*, PE funds seek to realize the gains made on their investments as soon as feasibly possible. During this time, GPs focus on realizing returns on the fund's assets. Some investments in portfolio companies will pay off handsomely, while others will not. During the disinvestment period, it is the GPs' job to discern which investments are worthy of additional funding and which should be liquidated. This decision is influenced by the PE funds' finite lifetime and the natural life cycle for the investee's development.

Many PE firms, especially those within the VC industry, operate on the assumption that "lemons ripen faster than plums" or "lemons mature faster than pearls." In other words, portfolio companies that fail will be more rapidly discerned than those that succeed. Portfolio company failure is an inevitable fact of the PE business. GPs must mitigate this failure by quickly rooting out failing firms and deploying the majority of their capital to winners rather than losers. The disinvestment period for "lemons" hopefully begins before "plums" and "pearls." GPs distinguish themselves by how they add value to investees facilitating their success and how underperformance or failure is averted.

It is the GPs' goal to realize all investments prior to the fund's liquidation at the end of the fund's lifetime. *Liquidity events* take place as companies are *harvested* by GPs, usually beginning around the fourth year of the fund. (Note that the term "liquidity event" is generally viewed in a positive light by those in the PE arena.) Portfolio companies are harvested through many types of exit strategies: an outright sale (to a strategic or financial buyer), an initial public offering (IPO), and merger are three of the most common exit strategies. Once a company is liquidated, proceeds are typically handled as follows:

- First, LPs receive return of their committed capital.
- Second, LPs receive a hurdle rate (6 to 8 percent) of committed capital.
- Third, return on capital (profits) are allocated among LPs and GPs.

In the third step, the ratio is typically 80 percent to LPs and 20 percent to GP. The GP return on capital is referred to as the GP's *carried interest* or *carry*.

Proceeds from U.S. PE investments are generally split between GPs and investors on a deal-by-deal basis. This is known as the *American waterfall model*, where the term "waterfall" denotes the agreed sequence of distribution of exit proceeds. If distributions occur long before the fund is liquidated, some capital may be reinvested in other portfolio companies, rather than being returned to investors. This activity largely depends on the provisions set forth in the *limited partner agreement* (LPA). This document memorializes the relationship between the GP and its LPs and specifies legal terms, such as the lifetime of the firm, the split of profits, management fees, and expense reimbursements. In contrast to the American waterfall model is the *European waterfall model,* where proceeds are not distributed until the fund has been liquidated. The European waterfall model has gained notoriety in the United States as influential groups, including the Institutional Limited Partners Association (ILPA) have recommended an "all-contributions-plus-preferred-return-back-first" (i.e., European waterfall) compensation model.[3]

Both waterfall models have pros and cons, but GPs generally prefer the American waterfall model while LPs generally prefer the European waterfall model. The American waterfall model allows the GP to receive its carried interest sooner, and this interest can be distributed to the partners or used as an equity contribution for a *follow-on fund*, or a fund that is raised subsequent to one currently run by a GP. The American waterfall model is moderated by a *clawback provision* to address the possibility for a GP to receive a large amount of carried interest for a successful, early portfolio company harvest, and the carried interest received for a quickly harvested, successful deal may exceed the total carry the GP should receive at the end of the fund. For example, assume a GP runs a $100 million fund and the LPA specifies 20 percent carried interest. Let us further assume the GP paid \$10 million for a portfolio company, the company grew rapidly, and the GP liquidated it for \$110 million. This harvest generates \$100 million of pretax capital gains, with the GP receiving \$20 million pretax of carry. Let us now suppose the remainder of the GP's portfolio was composed of failed companies. In this instance, the \$20 million of carry received by the GP would exceed 20 percent of the fund profits (\$100 million of pretax capital gains from the initial harvest sale, less \$90 million lost from the failure of the remaining companies). In this instance, a clawback provision in the LPA would be invoked, and the GP would have to return \$18 million of previously received carry.

Despite the ubiquity of Internet stock trading among everyday investors, direct investment in PE funds is generally not possible for many investors. Indirect investments in public PE firms such as Blackstone or Fortress Investment Group are, however, possible for the individual investor. This is in large part due to the fact that nearly all PE funds have a substantial minimum contribution size that is required of investors in order to participate in the fund. Often this hurdle will be specified in the LPA separately for institutional (i.e., pension funds, banks, etc.) and individual investors. Generally, the GPs will require a smaller commitment from individual investors than from institutional investors. The LPA of most funds prohibits follow-on funds until the previous fund has completed its "new names" investment cycle. Often the LPA "flattens" the fee structure of the combined funds so the GPs remain focused on delivering results from prior funds before diverting attention to raising a new fund and getting mesmerized by the allure of additional fee income.

Though the previous process aptly describes the lifetime of many PE funds, a PE firm may have multiple funds under its stewardship at the same time. Raising multiple follow-on funds is a central goal for GPs and allows them to turn a collection of limited-life funds into a lifetime business—should they be successful. GPs may raise a follow-on fund two to four years after the start of a previous fund; the time period between fundraising decreases as the economic climate and previous fund returns improve.

Raising a follow-on fund is no easy task and requires that the GP deliver high returns to its LPs. When a follow-on fund is raised, it is often labeled with a scheme that lets investors—and the public—quickly recognize long-term success, in spite of rather lackluster naming conventions. For example, suppose that there exists a new PE firm, "Nouveau Equity." Often, the first fund raised by a firm will bear a name similar to "Nouveau Equity," with future follow-on funds being named "Nouveau Equity II," "Nouveau Equity III," and so on. While the naming scheme is banal, it offers investors an at-a-glance understanding of the age of the firm.

Such names are also a source of pride and credibility for management, as it is no easy task for a firm to raise a large number of follow-on funds—the ability to do so speaks highly of the management team in place at a PE firm.

Successful PE firms are no different than other professional firms; they consistently produce above-average returns and do so with a consistent strategy. Professional investors in PE firms measure the performance of the firm's funds. Successful PE firms meet or exceed benchmark measures, build their professionalism, reputations, name equity, and stature. This building process is painstaking in today's competitive environment. It does not happen by chance and requires strong discipline.

THE LIMITED PARTNER AGREEMENT AND GENERAL PARTNER INCENTIVES

The LPA contractually binds both the GPs and LPs in a single, limited partnership agreement. Most PE funds are organized as limited partnerships, as opposed to C corporations—or any other structure for that matter, though an increasing number of PE funds are being structured as LLCs, where an LLC operating agreement would contractually bind the parties. For expositional simplicity, we will assume GPs and LPs are bound through an LPA and not an LLC operating agreement; the limited partnership structure remains dominant in the U.S. PE industry due to a well-established body of laws and practices concerning this organizational form.

In addition to specifying the lifetime of the firm, how capital commitments will be drawn, allocations and distributions, covenants and restrictions, carried interest, management fees, and expense reimbursements, the LPA discusses investment restrictions placed on the GPs, provisions for extending the fund's lifetime, commitments made by LPs, and actions taken should LPs default on their commitment.

While the GPs unquestionably require funds for investment in portfolio companies, these funds are not required at the fund's closing, though a pledge from the LP stating its commitment is included in the LPA.

LPAs generally specify that investors contribute a given percentage of their pledged capital at the fund's closing, usually between 10 and 40 percent. Future contribution dates may be denoted in the LPA, or the GPs may select these dates at their discretion—the latter is likely the case. Most funds draw down more than 90 percent of their capital by the time the fund is three to four years old and has completed the original investment cycle.

The LPA may also contain special provisions designed as a check on the GPs' power. In most cases, the LPs can replace the GPs if a majority believe that the GPs are not handling the fund's investments properly. (In some instances, LPAs require a supermajority, say, two thirds, to agree on such an issue in order for it to take place.) In extreme cases, the LPs may vote to dissolve the fund.

Although unusual, for one reason or another, an LP may default on its commitments to the fund; the penalty associated with such an action is often determined by circumstances. For instance, if a public pension fund were forced to withdraw from a PE fund due to changes in government regulations, withdrawal penalties would likely be waived. However, should an LP fail to respond to a capital call, the investor may be liable for interest and penalties, and in extreme cases, the LP may have to surrender its stake in the fund. Penalties may also be less harsh if the GP has a long-standing relationship with a defaulting LP that it would like to maintain. In such a case, the GP may recruit investors or permit the LP to sell its stake in the fund to another investor for fair market value on *secondary markets*.

Secondary markets for LP interests have developed dramatically since their beginnings in the early 1980s. They provide liquidity for investors whose PE investing plans and allocations may change during the life of such investments. Secondary investing has become a subclass of PE and many long-term PE investors have allocations to this subclass either directly, through specialized advisors or FoFs with this capability. In recent years, the secondary market has included a secondary direct category to facilitate direct investments in VC or PE investees through purchases from VC or PE firms, directly with investees, or through private placements. A celebrated deal in this category is the recent series of Facebook secondary purchases.

In addition to commitment levels and recourse provisions for LPs, the LPA specifies the fund's carried interest and management fees. With respect to the latter, the GPs—especially those of buyout funds—typically receive such fees dependent on the size of the fund, although some of today's largest funds continue to charge management fees commensurate with those of lesser size. A standard management fee charged by a GP ranges between 1.25 and 3 percent per annum of the fund's committed capital, with a 2 percent fee being highly common in the industry. Larger funds generally will charge investors a smaller management fee representative of the administrative economies of scale associated with running such firms (e.g., less paperwork and staff per dollar of committed capital). However, venture funds may charge a standard 2 percent management fee irrespective of the fund size as the economies of scale are considerably less for these funds than for their buyout counterparts. *Breakpoints*, or fund sizes in excess of which the management fee rate drops, are common.

Buyout funds purchase mature companies with well-known pasts. In contrast, VC funds seek out small, newly formed companies with promising ideas and strong management teams. While the buyout model permits GPs to acquire larger companies as the fund size grows (e.g., Bell Canada, TXU Corporation, Chrysler), VC firms invest in smaller firms in spite of their fund size.

Management fees are frequently scaled down once the investment period is complete and may be adjusted according to the proportion of the portfolio that has been divested. There exist, however, numerous differences across funds pertaining to management fee structure and the ramp down schedule. For example, some funds will not receive management fees from LPs after the fund's five-year mark has passed. Management fees are used to reimburse some fund expenditures, though numerous expenses are borne by the fund itself.

In addition to management fees, GPs also receive carried interest. Carried interest represents the primary incentive mechanism for GPs. The standard carry used in many PE agreements is 20 percent of the fund's profits, although a carried interest of between 15 and 30 percent is not uncommon; the most successful funds will be more likely to obtain higher carry. This form of return on investment serves to align the interests of the GPs with those of the LPs, as it incentivizes the GPs to generate strong investment returns. LPs receive the remainder of the fund's profits after the carry has been deducted. Gompers and Lerner found that over 80 percent of PE funds charged a 2 percent management fee and 20 percent carried interest.[4]

Carried interest has caused quite a stir in recent years as members of Congress have questioned the current practice of taxing carried interest as capital gains (with a maximum federal rate of 15 percent in 2011), rather than as ordinary income (with a maximum federal rate of 35 percent in 2011). Even Warren Buffet has weighed in on the issue.[5]

It is, however, little understood that GPs generally purchase their carried interest and this becomes part of their risk or "skin in the game." As previously stated, carried interest is generally subordinated to LPs' returns and does not accrue until LPs receive a return of their capital plus a preferred return. In this manner, carried interest works in a similar fashion as the entrepreneur's own investment, aligning the interest of the GP with the LP's desire for above-average returns.

Exhibit 1.3 presents a diagram of the complete private equity process, along with the fees received by each party.

In recent years, many LPAs and LLC operating agreements have specified a *preferred return* for PE investors. This return represents an annual return LPs are entitled to receive on their invested capital before GPs can receive any carried interest. A typical preferred return is 8 percent per annum, though many preferred returns fall between 6 and 10 percent of invested capital.

There exists a tremendous push among PE funds to achieve returns in the top quartile of all investments made by similar funds. Similar funds include those participating of the same *vintage year* (or year the fund was activated), industry, stage, and geography. Some LPs will examine funds by vintage year and quarter as numerous macroeconomic shifts affecting PE

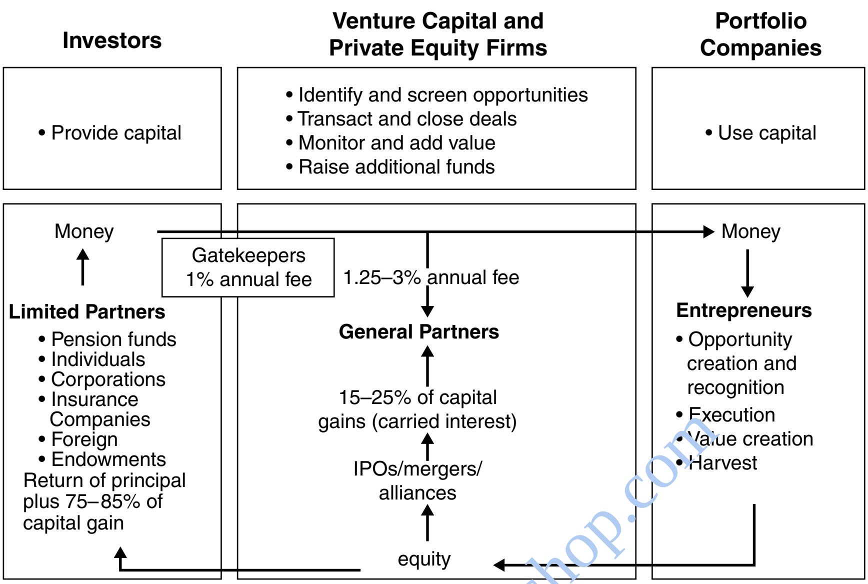

EXHIBIT 1.3 The Private Equity Process

fund performance might occur throughout a year (e.g., first quarter versus fourth quarter of 2000 or 2008).

As with a fine bottle of wine, PE firms with funds in the top quartile of their peers are revered by investors. When these firms seek to raise follow-on funds, they are generally oversubscribed, as investors attempt to gain access to these funds—past truly is prologue in PE. This is especially true in times where returns in other asset classes are subpar, as the "flight to quality" for many investors compels them to gain access to funds with strong track records. PE industry leaders distinguished themselves in the 2008–2011 period of extremely difficult economic times. The firms that intelligently supported investees during these times have demonstrated strong exits as the down cycle reversed.

PRIVATE EQUITY FIRM STRUCTURE AND SELECTED REGULATIONS

When compared with the total size of the companies that they invest in and oversee, PE firms are relatively small. Blackstone, KKR, and Texas Pacific Group (TPG) are three large firms at the center of the industry. Blackstone has a staff of 1,470 professionals in 22 offices around the world. This staff manages $150 billion in assets and portfolio companies with a total of

686,000 employees.[6] Smaller firms will often have significantly fewer personnel. A firm with $250 million in assets under management may have a staff of 20 to 40 employees; a firm with under $100 million in assets under management may have a staff of five to seven employees.

Many PE firms outsource functions to leverage their staff. Investment due diligence and operations assessments are sometimes performed by external advisors, effectively reducing the current staff size at PE firms.

In past decades, PE firms were composed almost wholly of GPs who were responsible for making all investment decisions, including portfolio company selection, management, and exit or harvest strategies. However, as the PE industry has grown, more staff-level employees and other executive staff members now comprise a significant portion of the employment in PE firms. Staff-level employees may include associates and principals, while a firm's executive staff now includes individuals with typical corporate-like titles, such as chief financial officer (CFO), chief executive officer (CEO), chief operating officer (COO), and chief legal officer (CLO), and chief recruitment officer (recruitment and HR are important value-add activities), among others.

While members of a firm's executive staff may play a role in the oversight of portfolio companies, these individuals are primarily focused on deal flow development of the PE firm; however, they are sometimes involved in *term sheet* (an initial document presented to a prospective portfolio company summarizing key terms of an *investment agreement*) negotiations and planning the harvest of portfolio companies.

In order to minimize administrative burdens placed on firms and to ensure that fund qualifies for exemption from numerous registration requirements, minimum capital commitment levels are kept relatively high. In this manner, many PE funds have few investors in order to qualify for an exemption available under Rule 506 of Regulation D of the amended Securities Act of 1933.[7] Exemption from this Act is favorable due to the considerable costs, public disclosure obligations, and compliance obligations associated with registration.

Many Regulation D exemptions require that securities or fund interests be offered only to *accredited investors* or a maximum of 35 unaccredited investors. Dodd-Frank changed the definition of "accredited investor." Prior to Dodd-Frank, a person was an accredited investor if (1) such person had an individual income in excess of $200,000 in each of the two most recent years or joint income with their spouse exceeding $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; or (2) such person's net worth, together with their spouse, exceeds $1 million at the time of purchase. For the purpose of determining net worth, individuals previously could include the value of their primary residence. Under Dodd-Frank, individuals may no longer include the value of their primary residence for the purpose of determining net worth under the accredited investor definition. Other provisions of the accredited investor definition remain unchanged. Large, 501(c)(3) organizations, corporations, business trusts, and partnerships not formed for the specific purpose of acquiring securities are accredited investors if they have in excess of $5 million in assets.

Regulation D imposes very specific restrictions on the solicitations funds may use to raise capital. Specifically, no mass mailings, advertisements, press releases, or informational seminars are permitted. However, funds may engage in solicitation with investors with whom they have preexisting business relationships and with investors who are believed to be accredited.

Furthermore, fund managers may not provide information to nearly any type of publication (those of both wide and limited circulation) for the purpose of fundraising; even general articles about a fund and its managers are frequently avoided given that they may be viewed as a promotion of a fund by the SEC. *Tombstone* ads and press interviews discussing the fund are generally permissible after the fund has ceased fundraising. Formal interviews with the press are rarely granted by GPs, as the GPs do not want to have their actions misconstrued as promoting their next fund.

Dodd-Frank significantly increases the regulation of PE firms, particularly those that manage one or more private funds. Per Dodd-Frank, a private fund is a fund that is exempt from the definition of investment company under the Investment Company Act of 1940 (IC Act). This exemption occurs due to Sections 3(c)(1) and 3(c)(7) of the IC Act, and generally includes VC and PE funds.

Prior to the passage of Dodd-Frank, PE funds commonly maintained exemption from registration as investment advisors by advising fewer than 15 clients. This exemption was permitted under Section 203(b)(3) of the IC Act. After July 21, 2011, this exemption was eliminated, meaning fund managers must register with the SEC unless they can rely on another exemption from registration.

Dodd-Frank also narrowed another exemption from the Investment Advisers Act of 1940 (IA Act). Under this exemption, a VC or PE fund was exempted from registration under the IA Act if the fund did not provide advice regarding securities listed on a national exchange and all of its clients were residents of the state in which the fund had its primary office and place of business. Dodd-Frank, however, does contain several new exemptions from registration with the SEC under the IA Act. These include exemptions for (1) an investment advisor to one or more venture capital funds and (2) an investment advisor that manages only one or more private funds and that has aggregate assets under management of less than $150 million.[8]

Other regulations, such as the Employee Retirement Income Security Act of 1974 (ERISA), weigh in heavily on investment in PE funds. ERISA was enacted primarily to protect the interests of participants in employee benefit plans and their beneficiaries, and it requires plans to supply participants with detailed information. Specific plan features and funding must be disclosed to participants. The act also "provides fiduciary responsibilities for those who manage and control plan assets; requires plans to establish a grievance and appeals process for participants to get benefits from their plans; and gives participants the right to sue for benefits and breaches of fiduciary duty." ERISA has been amended multiple times over its life. These changes, according to the U.S. Department of Labor, were aimed at "expanding the protections available to health benefit plan participants and beneficiaries."[9]

When originally passed in 1974, ERISA instructed pension plan managers that they should invest plan assets "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." This is generally known as ERISA's Prudent Man Rule. As such terms were initially quite vague, some plan managers believed that the act forbade them to invest in risk capital such as PE. Institutional investments in the PE arena soon plummeted after the act's passage on September 2, 1974. It was not until 1979 that the Department of Labor clarified ERISA's Prudent Man Rule, explicitly permitting pension fund managers to invest in PE.

Despite the aforementioned clarifications to the Prudent Man Rule, ERISA still limits the participation of pension plans in PE. Aside from special exemptions, PE funds are not permitted to raise more than 25 percent of the capital for a given fund from pension "benefit plan investors." If the fund qualifies as either a VC, real estate investment, or distressed investment operating company, it may be exempt from the above requirements; however, these qualifications are not easy to achieve.

The U.S. Pension Protection Act of 2006 also bore significant influence on PE funds with respect to ERISA regulation, especially the act's revised definition of a benefit plan investor. Whereas previously the definition included employee benefit plans subject to ERISA, it also included government and foreign country benefit plans; these latter two types of benefit plans are now excluded from the definition. FoFs also benefited from this piece of legislation: Only 50 percent of an FoF's ERISA contribution to a PE fund is counted as part of the 25 percent rule.

As evidenced by the above-mentioned plethora of regulations (which still only represent a fraction of those to which PE funds must adhere), raising a PE fund is no simple task. Because of these regulations, the LPA often specifies a minimum and maximum number of investors, along with minimum commitment levels for investors. The targeted fund size is also specified in the agreement as a range, determined by both the general and limited partners.

If the GPs are not able to raise enough capital to meet the lower level of this range, the fund is not allowed to close, and commitments are released. In contrast, the LPs also have a vested interest in not allowing the fund size to grow too large. In such a case, the administrative duties of the GPs may become unbearable, and the GPs' management team may become stretched too thin managing many investors.

Investors will usually permit GPs to exceed the prespecified maximum fund size by a small amount (i.e., 5 to 15 percent), although all LPs must agree to such terms. In some instances, LPs have even permitted the GPs to reopen a formerly closed fund to raise additional capital (e.g., Blackstone Capital Partners V). Such a rare step might be taken because of the LPs' fears that they would be excluded from future funds should they vote against the fund's reopening.

This instance alludes to an important issue in the current PE arena: access to top-tier funds. While the number of PE funds has continued to grow in size, there continually exists a push for LPs to invest in follow-on funds managed by firms that have demonstrated superior past returns in previous funds. As discussed in a previous section, LPs usually look to invest their capital in firms that have demonstrated fund returns in the top quartile of all those in a similar investment area.

In addition to possessing strong historical track records, institutional-quality funds are run by GPs who have demonstrated an ability to "get deals done" in the past, and they generally accept contributions only from LPs with whom they've had ongoing relationships. The "star quality" of such funds and their managing firms frequently overshadows other, smaller funds in the PE market.

As such, start-up PE funds, or those with lesser track records, have a significantly harder time raising capital than do those funds with historical returns in the top quartile. However, one way in which new and smaller funds can attract first-time investors is by investing a considerable amount of their own capital in the new fund—this contribution will also be specified in the LPA.

Prior to the enactment of the Tax Reform Act of 1986, GPs were required to put up 1 percent of the total capital in a fund (the 1 percent rule). In these times, even in the top quality firms, LPs expect GPs to invest much more than one percent in their fund. Nonetheless, the GPs of well-established funds continue to finance approximately 1 percent of the new fund in order to provide investors tacit assurance that they have significant "skin in the game." Moreover, some LPs require that the GPs contribute more than 1 percent of the fund's capital in order for them to invest in the fund. This is generally true for small- to mid-market funds.

TYPES OF PRIVATE EQUITY INVESTMENT

There are many types of private equity investment; however, this book primarily focuses on VC and buyout transactions. Exhibit 1.4 presents a taxonomy of PE investments that will be described in this section.

At one end of the spectrum lies *angel investing*. The national angel market in recent years has grown dramatically and in 2008 was more than twice the size of the VC industry in financing early-stage investees. Although it has gained considerably more structure in recent years, the market for angel capital remains rather informal, as is often arranged by word-of-mouth. Frequently, lawyers or other business professionals will refer companies to investors through personal recommendations.

Angel investors are generally high-net-worth individuals who invest in companies with a feasible idea; prototypes of future products may or may not have yet been developed when the investor is first approached. In order to compensate these investors for the large risks they must bear, they generally require relatively large equity stakes or invest in convertible debt securities. Such convertible structures might allow an angel investor to forgo a valuation of the investee (a considerable task involving much guesswork at this stage of the company's life) and resist future cramdowns through recapitalization by subsequent investors. Convertible debt also allows an angel investor to "ride the upside" of his investment through conversion to equity.

Despite their interest in the company, the typical angel investor rarely exercises control over the business; the day-to-day operations of the business are left to the entrepreneur, or the management team, although the investor may provide the investee with advice.

Investors in firms with a little more maturity than those funded by angels are called seed investors. These individuals also make equity investments in fledgling firms, but the idea upon which the firm has been formed has a higher probability of success. Seed money may be used to recruit management or increase research and development expenditures so that a product may be refined for sale. Many PE professionals regard seed funding as the first level of early-stage VC.

More mature firms seeking early-stage VC will present complete sound business plans and prototypes of commercially feasible products. These

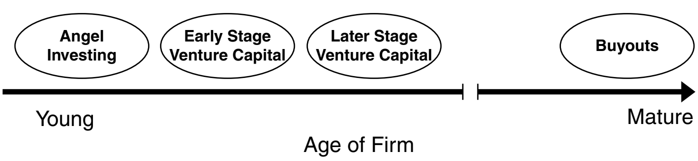

EXHIBIT 1.4 Private Equity Investment Categorized by Age of the Portfolio Company

firms will employ their funding to construct manufacturing facilities and establish a supply chain for their product so that it may be sold to retail customers. Such firms may also use their VC to build inventory.

The most mature of firms seeking early-stage VC may already be turning a profit, but they require further injections of cash in order to fund the fast-growing business; opportunities for investment may outstrip the current cash flow of the business. If they possess collateral and, at a minimum, a brief history of profits, these firms may also seek bank financing. Restrictions on banks have limited such loans in recent years except for those banks skilled in backing loans with SBA guarantees.

As is the case with angel investing, providing early-stage VC is a long-term commitment. Returns on investments may not be realized for many years, and the investments are highly illiquid. These risks are mitigated by the commensurate stakes these investors generally demand.

Firms that possess fully developed products with proven technology may seek later-stage VC. These firms have a track record of profitability, but may require further cash injection in order to grow the firm beyond what the current level of working capital permits. Also, if early investors wish to cash out of the firm prior to a liquidity event, later-stage VC can be used to facilitate this need.

Many VC investments are made in stages. A primary investment is made, and further capital is not committed until the portfolio company is able to meet a milestone specified by the terms of investment. This phenomenon of *staged capital* permits investors to limit their downside risk, while allowing entrepreneurs to retain larger equity stakes in their company.

If a portfolio company received all of its funding up front, investors would be squeamish about the entrepreneur squandering the cash, and, moreover, the entrepreneur would have to grant his/her investors a large equity stake to receive this funding. By injecting capital in stages, the business is allowed to appreciate in value before further cash infusions are required. As the business's value increases, the entrepreneur can give up a smaller piece of his/her equity in order to receive an infusion of cash. Successful VC investors use such staging to ensure their capital is used efficiently and focused on steps or milestones related to the investee's business plan.

At the opposite end of the spectrum from VC investments lie buyout deals. These transactions focus on the acquisition of mature public or private companies or subsidiaries of such companies that often have experienced a short-term "blip" in earnings. While historically the company may have produced strong returns for investors, because of market forces or poor management, they may have experienced a recent downturn that the buyout team believes they can remedy.

When searching for potential buyout targets, GPs look for firms with strong, stable cash flows, market leadership, a well-seasoned management team, and a low debt-to-equity ratio relative to industry peers (i.e., a conservative capital structure). Cash is king in leveraged buyout (LBO) transactions, as cash payments are used to service the debt raised in the deal—not earnings. Moreover, in possessing these qualities, banks will be more likely to lend large amounts of debt to the target firm, as each of these traits increases the probability that the company will make its interest payments in a timely manner. Because of the large amounts of debt used in buyout deals, they are often referred to as LBOs.

While VC investments are typically all-equity deals or use subordinated debt, buyout investments are often funded with large amounts of debt. Control of a company is assumed by buying out the current shareholders with capital derived from a combination of debt (from lenders such as banks) and equity (from PE funds). Due to the high level of debt in buyout transactions, buyout GPs strictly monitor their portfolio companies' cash flow.

In the late 1980s, leverage multiples were especially high as buyout funds pushed the limits on debt financing; average leverage multiple for all LBOs was 8.8 times earnings before interest, taxes, depreciation, and amortization (EBITDA). By 1992, however, this multiple had decreased to 6.0 times EBITDA with the savings and loan crisis and the subsequent recession that resulted from it.

As the economy continued to grow at record pace in the mid-to-late 1990s (real gross domestic product [GDP] growth averaged 4 percent per year from 1994 through 1999), banks became more lenient, increasing debt multiples, though today leverage multiples are well down from highs seen in 2006 and 2007.[10]

THE PRIVATE EQUITY FUNDRAISING PROCESS

One of the most important topics in the modern PE arena is fundraising. As many funds raised massive sums of money through the second quarter of 2007—some in the tens of billions of dollars—fundraising was often at the forefront of many news articles and discussions centered on the arena. Although the current credit markets and the macroeconomic climate have put a significant damper on current fundraising levels, it is nonetheless important to understand why some PE funds experienced such high rates of investment in recent times, and also how the fundraising process works.

There are four principal parties that are at the heart of all PE fundraising processes: GPs, LPs, gatekeepers, and placement agents. As discussed in a previous section, the LPs pledge capital commitments to the GPs, who are then responsible for investing these funds in portfolio companies. In some instances, third-party investment advisors (aka gatekeepers) may also be involved in the fundraising process. These advisors, such as Cambridge Associates, Abbott Capital Management, Credit Suisse First Boston, and Venture Economics, assist the LPs in making PE investments. They are extremely knowledgeable about the industry and generally track the performance of funds and firms, issuing recommendations to LPs about where they should invest their funds. The GP counterparts to these investment advisors are called *placement agents,* or firms that the GPs hire in order to attract capital. Some of the world's largest investment banks, such as Goldman Sachs, have placement agencies. The agents charge a fee for providing this service, with the cost largely being a function of the new fund's size and the GPs' current status as a PE investor. For instance, the fee charged to a smaller, new, non-follow-on fund with a fledgling management team may be as high as 3.5 percent of the fund's total committed capital; the fee for identical services for a large fund run by well-established GPs may be as low as 0.5 percent of committed capital.

While the majority of a PE fund's assets are put up by the LPs, the GPs almost always contribute some capital toward the fund, typically 1 percent of the fund's *corpus* or total fund size. As discussed above, GPs may contribute more than this customary amount.

Raising a new fund has never been an easy task. The recent popularity of well-established PE firms raising mega-follow-on funds has made such a task even harder, crowding out newer firms. Investors want to see top-quartile returns in previous funds and a seasoned management team as GPs with a track record of success, and they want to invest in a fund led by a PE firm with significant brand equity. Despite copious enticements (e.g., lower management fees and carried interest), LPs may still prefer to invest in a fund managed by a tried and true GP. Nonetheless, in order to encourage LPs to invest in new funds, GPs may put up a larger than normal portion of the fund's capital. Such an act serves to demonstrate to potential LPs that the GPs have significant skin in the game and, presumably, confidence in their investing abilities. Such an action may also help a fund surpass a threshold size, permitting it to garner more attention (e.g., the $100 million, $500 million, $1 billion, or $10 billion level). Additionally, the GPs of new funds may hire placement agents in order to raise additional capital. There currently exist agents who specialize only in new funds. Recognizing that some new funds have well-motivated GPs, several FoF Managers have charters to seek out newer and first-time funds. This has led to innovation in strategies and some regional funds to attract institutional investors.

In general, the GPs of new funds will likely find a pool of investors to help finance their funds if these GPs have previously worked for name brand firms, if they have executed and harvested many successful deals, and if the macroeconomic climate is favorable to their strategies. Without such a personal track record and a stable economic climate, GPs attempting to raise new funds will struggle.

LPs place capital with established GPs raising new funds for several reasons, one of which is the difficulty LPs experience in attempting to gain access to established, brand-name, top-tier funds. PE GPs and LPs seek to establish long-standing relationships with one another. Most firms overseeing top-quartile funds already have such relationships with large public body and corporate pension funds, insurance companies, foundations, endowments, family offices, and high-net-worth individuals. As such, when a new follow-on fund is raised by a top-quartile firm, the necessary commitments are generally oversubscribed. Not only do those firms with established relationships want an LP interest in the new fund, so, too, do a large group of investors attempting to gain access to these funds. Unfortunately, however, many of these investors are not granted access to such funds because of the enormous popularity that top-quartile funds generate—everyone is clamoring for a piece of those pies. For these reasons, some LPs may turn to less well-established funds to invest their money.

LPs might also place capital with well-established GPs raising new funds due to exemplary personal track records. New PE firms have been established when GPs break away from established firms to start new firms and funds to reap a greater portion of economic benefits from the investing process. While younger GPs might support a significant fraction of the workload at an established fund, they may not receive a proportionate share of carried interest; a large portion of carried interest frequently goes to partners with "their name on the door" and the co-founders of PE firms. By starting their own fund, an established PE professional will have a chance to reap greater rewards from managing LPs' capital.

When LPs invest in PE funds, they pay close attention to dealmakers at the fund level, and may, in some instances, entice an established professional to leave his current post by promising to commit capital to a new fund he manages. LPs want to place capital with those who are highly incentivized to deliver stellar returns; this might best be exemplified by a professional who has "earned his stripes" at an established fund, but now wants to break out on his own and establish a reputation.

GPs of new funds may also find investors by looking for LPs who have motivations beyond those of financial returns. For example, some university endowments may seek to invest a certain portion of their capital in funds that are located close to such universities; the same might be the case for state pension funds or even corporate pension funds. This is particularly true of LPs located in California, Colorado, Oklahoma, Indiana, and Ohio. These organizations believe that by setting aside a portion of their capital for such investments, they are contributing to the economic well-being of their home state. Individual investors—as opposed to institutional investors—may also be more receptive to investments in such funds, as many are considerably more risk-prone than institutional investors.

Some newer funds may also try to take a very specific industry focus with respect to new investments. This strategy caters to the fact that many LPs are now trying to achieve better portfolio diversification by amalgamating groups of specialized funds. Such a tactic has recently worked well for many mid-market funds.[9]

A final tactic GPs may use in trying to attract new investors is the use of a lead investor (aka special LP). In order to obtain such a title, a lead investor will contribute a large portion of the fund's capital, and may even help subsidize the GPs' marketing costs. In return for such services, the lead investor may receive a portion of the fund's carried interest, on top of an already substantial portion of the fund's distributions. However, it is important to note that the use of a special LP may scare away some potential investors who recognize that this investor will require a substantial portion of the firm's distributions in return for the risks it must bear.

RECENT FUNDRAISING TRENDS

The current trend toward investing capital with large PE funds is a direct result of the LPs' increasing desire to invest in funds with excellent historical track records, and also the aforementioned changes to the U.S. Pension Protection Act of 2006. Provisions of this act have made it possible for government pension funds to invest large sums of capital in funds, without having to maintain their contribution level below 25 percent of the fund's total assets. This has allowed some states with large pools of assets to contribute significant amounts of capital to top-tier funds.

PE *mega funds*, or funds generally managing more than $1 billion in capital, are also making it continually harder for funds of smaller size to find qualified investors, as these smaller funds may not possess the brand equity of their larger brethren. In the current PE arena, nearly all LPs want to invest in funds with firms that have historical top-quartile performance and high brand equity. As many GPs will maintain strong business ties with their LPs (recall the example at the beginning of the chapter of CalPERS and Blackstone), this makes it very difficult for new investors to contribute capital to top-quartile funds.

In some cases, GPs who had previously managed successful PE funds with a parent firm will leave the company and start their own fund—or GPs may elect to stay with the PE firm while starting a new fund using their own personal capital. An example is Vinod Khosla, a partner at the VC firm Kleiner Perkins Caufield & Byers, starting his own venture firm, Khosla Ventures. Khosla is known within the VC community as a prominent deal maker and had been highly recognized by both *Forbes* and *Fortune* magazines.[11] He was a co-founder of Daisy Systems and founding CEO of Sun Microsystems. Khosla focused his new firm on green technologies and launched the firm with the full support of Kleiner Perkins.

In some instances, GPs who leave large firms to start their own funds are highly successful, while others are not. When evaluating whether to invest in such a fund, LPs seek to discern if a GP's success was rooted in the firm's "secret sauce," or through the tenacity of the individual. Along these lines, the LPs will have intense discussions with the individual managing the new fund and attempt to discern just how much skin they had in the game on each of the deals listed on their resume.

LPs will grill the prospective fund manager about who specifically scouted the deal, who arranged the financing, and in what financing rounds the LP's firm participated. Was the deal actually originated and shaped by the individual or someone else in the firm? Did another investor participate in the first round and then bring in this individual's firm for the second round (a safer investment)? Questions such as these, supplemented by numerous phone calls from one LP to another, serve as a principal form of due diligence employed by investors.

Active due diligence pursued by LPs can also help weed out possibly naïve, new fund managers who are purely chasing trends. With so many alternative investment vehicles participating in today's financial arena—most of which were subject to little governmental regulation prior to Dodd-Frank—there are sometimes managers who will try to lure investors to a "flavor of the month" fund. These managers constantly vacillate in focus. They attempt to raise buyout-focused funds when the buyout market is hot (i.e., circa 2007), VC funds when venture is hot (i.e., circa 1997), real estate funds when they're hot, and so on. It is important that the investor be on the lookout for such managers and funds, and that due diligence is actively pursued before committing any capital to an investment.

GENERAL PARTNER INVESTMENT RESTRICTIONS

While the GPs are the administrators of PE funds, there are often restrictions placed on their activities, to which they are contractually bound. At first blush, one may think that the LPs can largely shape the investment decisions of the GPs, serving in somewhat of a board of directors role. LPs are not permitted to direct the day-to-day operations of the fund if they are to retain limited liability status. This detail highlights the extreme importance of the LPA provisions, as the LPs have little say in the fund investment strategy once they commit capital.

Within the LPA are frequently a series of covenants binding the GPs. Although such covenants have now become commonplace, they were virtually nonexistent until the 1980s when venture returns began to sag (see Exhibit 2.9 for further information). During this time period, some LPs felt that their investing counterparts had strayed from the original focus of the fund and, in the process, had invested money in areas where they lacked expertise; the result was lackluster returns and the genesis of covenants in LPAs. Today, in addition to restrictions on the types of investments GPs may make, covenants also specify other numerous restrictions, such as restricting the size of an equity investment a GP may make in a potential portfolio company.

LPs seek to maximize returns while minimizing risk. GPs are expected to deliver such returns.

If the GPs of a fund have invested only a minimal amount of money in the fund (i.e., 1 percent of the fund's assets at closing or less), then they are, in a sense, risk-prone investors. They have little to lose on their initial investment, and a large percentage of carried interest to gain should the investment pay off. In contrast, the LPs are considerably more risk averse than the GPs, since they stand to lose a substantial amount of capital should the fund not generate adequate returns.

In this way, covenants limiting GPs' contributions to portfolio companies are advantageous for LPs as they limit the GPs' ability to invest in a "walking dead" investment, one that requires a lot of cash but produces little in return. A GP may be motivated to invest significant portions of cash into such a company in the hopes that a capital infusion may set the business on track, while the LP would rather cut his/her losses and invest the capital elsewhere. Such covenants are usually expressed as a percentage of the fund's contributed capital or market value of the fund's assets (e.g., not more than 10 percent of the fund's contributed capital may be invested in a single portfolio company).

Furthermore, as many successful PE firms go on to raise follow-on funds, LPAs also contain covenants restricting the practice of having these funds invest in a previous fund's portfolio company. For instance, if "Nouveau Equity" invests in a portfolio company, "Nouveau Equity II" will likely be restricted by its LPA in investing in said company. These covenants are used to prevent GPs from infusing additional capital into a declining company.

As described in previous sections, GPs are under constant, unrelenting pressure to produce returns in the top quartile of all funds. Though many GPs possess high integrity, the quest for this lofty position can potentially entice GPs to make unethical decisions without the use of proper covenants.

Covenants may also restrict the GPs' use of debt in financing portfolio companies, requiring total debt levels to remain below a threshold value based on a percentage of the fund's assets. These covenants became popular after some PE funds in the 1980s used above-average levels of debt to finance portfolio companies with the hope that they would have a better chance of growing faster.

A final type of covenant that commonly appears in LPAs is one that relates to the reinvestment of fund profits. Without such covenants, GPs, motivated by yearly management fees, might attempt to increase their wealth by investing intermediate distributions in investments they well know will not pay off by the end of the fund's life. With the LPs' consent, the GPs may then try to extend the fund's life in order to obtain more yearly management fees. Furthermore, as some GP management fees are based on a percentage of the value of assets under management, returning distributions to investors may decrease these fees.

CONCLUSION

This chapter has presented an introduction to PE finance, including an overview of the PE fundraising process, recent fundraising trends, selected regulations, and investment restrictions placed on GPs. Key terms have also been introduced to the reader. While PE was a largely dormant asset class through the late 1970s, PE investments now represent a significant fraction of many institutional investors' portfolios.

NOTES

1. *Source:* http://www.sec.gov/news/press/2011/2011–133.htm.
2. *Source:* Thomson ONE Banker database.
3. Institutional Limited Partners Association, "Private Equity Principles: Version 2.0," January 2011.
4. P. Gompers and J. Lerner, "What Drives Venture Capital Fundraising?" NBER Working Paper No. 6906.
5. *Source:* http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html.
6. *Source:* http://www.blackstone.com/cps/rde/xchg/bxcom/hs/firm.htm.
7. *Source:* http://sec.gov/about/forms/regd.pdf.
8. For the Dodd-Frank definition of a VC fund, see http://blogs.wsj.com/venture-capital/2011/06/22/sec-adopts-vc-definition-gives-funds-20-latitude-to-do-other-deals/.
9. For further information, see www.dol.gov/dol/topic/health-plans/erisa.htm.
10. *Source:* Standard & Poor's LCD Comps reports.
11. For further information, see www.khoslaventures.com.