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FRDNY June 2015

Roslyn's Basic Intro to Investment Advisers: Private Equity, Venture Capital & Hedge Fund Firms

*Please consider this a **general guideline** for how **typical** investment advisers operate. Many firms do not fit these models. Also, some firms have divisions or funds in more than one category. Before estimating a prospect's income or wealth, find out as much as possible about his/her role at the firm and which fund(s) he/she is connected to.*

Private Equity Firms

- Invest in a company and implement changes to increase value or profit. Sometimes the company is broken up and sold in pieces.
- Buy whole or partial ownership stakes & typically sell (or "exit") in 5 to 7 years.
    - Capital commitments (legal agreements to reserve & provide money) are usually medium- to long-term.
    - Firms often use borrowed money to finance changes. The debt burden is usually held by the company, not the PE firm.
- Each PE firm may have multiple funds. Each fund is created to focus on a particular business type, sector or strategy and invests in multiple companies.
- The lifespan of a fund is usually 10 years, but is sometimes extended to 11 or 12 years. Typically, the first 3 to 5 years are spent identifying and investing in companies. In years 7 to 9, the firm is engaged in or preparing for exits.
- Most of a PE fund's assets are owned by outside investors. These clients are usually pension funds, foundations and endowments, but can also include high-net-worth individuals. The investors commit capital for the life of the fund.
- Sources of income for the PE firm include:
    - Management fee charged to clients - typically 1% to 2% charged quarterly or annually.
    - Performance fee (aka "carried interest" or "carry") charged to clients - typically 20% of net profits for all deals in a fund after "hurdle" rate of approx. 8% of total invested capital.
    - Advisory fees and transaction fees may also be charged to the company acquired or final buyer.
- Individual investment professionals (non-administrative employees) typically receive a base salary plus an annual bonus. More junior execs receive a bonus based quality of work contributed. More senior execs receive a bonus tied to the success of deals he/she has worked on directly. (Bonus income received in 2011 might be from a deal started in 2004.)
- Execs with an ownership stake typically receive a base salary plus an annual bonus tied to the success of all deals at the firm.

Venture Capital Firms (a subset of Private Equity)

- Invest in an idea or early-stage company with the potential for high growth.
- Provide financing (in multiple "stages" or "rounds") in exchange for an ownership stake & typically sell (or "exit") in 7 to 10 years.

- Some firms specialize in one particular stage of growth or set of industries.
    - Capital commitments are usually short-term, giving the firm the chance to walk away before providing another round of financing.
    - Firms expect about 30% to 40% of ventures to fail or make a minimal profit.
    - After the company is sold (privately or through a public offering of stock), there are often restrictions on how much of the VC's stake can be sold and when.
- Most of a fund's assets are owned by outside investors. These clients are usually pension funds, insurance companies and endowments, but can also include high-net-worth individuals.
- Sources of income include:
    - Management fee charged to clients - typically 1 % to 2% collected quarterly or annually.
    - Performance fee (aka "cost of carry" or "carry") charged to clients - approx. 20% of net profits for all deals in the fund after the hurdle rate.
- Individual investment professionals (non-administrative employees) typically receive a base salary plus an annual bonus. More junior exec bonuses are typically tied to work quality. More senior exec bonuses are typically tied to the success of deals he/she has worked on directly. (Bonus income received in 2011 may be based on a deal started in 2001.)
- Execs with an ownership stake typically receive a base salary plus an annual bonus tied to the success of all deals at the firm.

Hedge Funds

- Invest in markets, not necessarily a particular company, by predicting (or betting) what will happen in the near or long term.
- Ownership stakes (or "positions") can last seconds, days, or years.
- Fund assets are owned by outside investors and the firm at varying levels. Sometimes the fund manager(s) personally owns the majority of assets under management (AUM). Clients seek high returns, accepting high levels of risk. They often agree to a "lock-up" period during which they cannot take their money out of the fund, even if it's losing money.
- Sources of income:
    - Management fee charged to clients - typically 1% to 2% collected quarterly or annually.
    - Performance fee - typically 20% of net profits annually.
- Individual investment professionals (non-administrative employees) typically receive a base salary plus an annual bonus. More junior execs typically receive bonuses tied to quality of work. More senior execs typically receive bonuses tied to the success his/her individual investment decisions that year. (Bonuses awarded in 2011 are usually based on 2010 performance, but may be subject to deferred payments or claw backs.)
- Execs with an ownership stake typically take a cut of all firm profits for the year.

More on Fees

- ***Performance fees*** are difficult to calculate with any accuracy or confidence. You may be able to ballpark net profits from a single deal, but estimating net profits for all deals in a particular fund is much harder. Estimating performance fees at hedge funds is the hardest of all. Because of the fast pace and high degree of risk, HF performance fees are subject to the most terms and conditions (e.g. claw backs, high water marks). The details are not publicly available.

- While individual investment pros may receive a high bonus based on profits from a single deal, the firm and its owners must balance payouts with any losses a fund might suffer over the course of years. *If enough deals in one fund do poorly, the firm may net $0 from performance fees that year.*
- ***Management fees*** are used to cover day-to-day expenses and base salaries.
- ***Percentages*** may vary by client and/or fund and not all assets under management (AUM) are subject to fees. Check Part 2 (the Brochure) of the firm's SEC Form ADV where they often disclose the applicable percentages.

Cash vs. Carry: Considerations for Your Prospects

Firm vs. Fund

- One firm can manage several funds, each with a different investment type (private equity, venture capital, hedge, etc.).
- These distinctions are important because Research uses assets under management (AUM) or Committed Capital (from investors), as a starting point to estimate compensation.
- For example, Bain Capital has more than 15 funds and four additional affiliates across at least four investment types.
- Bain Capital – the firm – has about $32 billion in AUM. "Bain Capital Partners VI" – the fund – has about $33 million in AUM. "111 Capital LP" – the fund at an affiliate – has about $30M in AUM.
- Since Bain Capital VI is a private equity fund and 111 Capital is a hedge fund, they have substantially different compensation practices.

Partnership vs. Ownership

- Partnership is mostly about title and seniority. Partners usually have a small equity stake in the firm, which may or may not have a market value.
- Partnership is typically achieved after 7+ years of service or when an already established professional joins a firm.
- Ownership refers to an individual's membership in the GP and dramatically affects his/her compensation. Members of the GP split the lion's share of the firm's carry - across all funds - every year.
- Depending on the individual's role and the structure of the firm, he/she might receive a predetermined percentage of the fund and/or firm's carry even though he/she doesn't hold an equity stake and is not a member of the GP.

Types of Legal Organization

- The majority of PE & VC <u>firms</u> based in the US are legally organized as **Limited Partnerships (LPs).**
- The next popular option is Limited Company (LC) aka **Limited Liability Company (LLC).** Unlike LPs, LLCs may be owned by a single member.
- Hedge Funds <u>firms</u> may also be organized as LPs, but LLCs are more common among HFs than among PE/VE firms.

- Interests in both LPs and LLCs are considered **“securities”** and therefore regulated by the SEC.

Conceptual Example: A Simplified Story of How PE, VC & HF Firms Invest

Phase 1 -Venture Capital

- You have a fantastic new lemonade recipe, but don’t have enough money to buy the supplies you need.
- VC Firm thinks the recipe is worth $1M. They give you $100K (in exchange for a 10% stake) to quit your day job, buy ingredients and help you perfect the process.
- 7 years later, you sell the recipe to BevCo. for $5M. You get $4.5M and the VC firm gets $500K.

Phase 2 – Private Equity

- BevCo makes huge batches of lemonade in its factory. The flavor suffers and sales are lower than expected.
- PE Firm thinks the product is good but the process is suffering because of bad management. It buys the recipe from BevCo for $3M.
- PE Firm spends another $1M to hire dozens of “grannies” to make small batches in their kitchens. They hire “grandkids” to sell bottles from little stands on street corners.
- 7 years later, the grannies and kids are a hit and the PE firm is ready to cash out.
- It sells the granny & kid employment contracts and the recipe to ThirstCo Organics for $10M.
- During that time, the PE firm charged investors in the GranLem Fund a 1.5% management fee (1.5% of $4M x 7 = $420K) to cover PE Firm’s operational expenses.
- They also charge a 20% performance fee on the $6M profit, so the PE firm will get $1.2M and the investors will get $4.8M. (See ***Intermediate Clarkenomics*** for more math.)

Phase 3 – Hedge Fund

- Hedge Fund hears about ThirstCo’s plans to enter lemonade business. They spend $6M (1.5M shares at $4 each) to buy stock in organic lemon fertilizer.
- When ThirstCo starts production, the stock rises quickly and the Hedge Fund sells at $7 a share for a profit of $4.5M.