

INVESTING IN THE PRIVATE MARKETS

Focusing on the fundamentals



INTRODUCTION

Over the past two decades, and particularly in the years following the global financial crisis, private markets around the world have experienced a dramatic influx of new investors and capital.

Dynamic new products and innovative technologies have driven increased accessibility, regulatory reforms have brought more transparency to the industry, and private market investments have performed well relative to public equities over a sustained period of time.

The result has been rapid growth for an industry that hasn't always been easily accessible. While it took private investments a half-century to reach \$2 trillion in assets, it took only ten years, from 2007 to 2017, for assets to more than double to over \$5 trillion.² Going forward, private market assets are expected to increase by nearly 60% over the next five years, which would push them past hedge funds as the largest alternative asset class.³

An important consequence of this growth is that many investors now view private markets as an essential and core part of their overall asset allocation. While private investments can add significant value to a portfolio, it is sometimes difficult to understand how they differ from other, more traditional asset classes.

This document draws from experiences and lessons learned over 35 years of private market investing. We hope these insights further enable investors to maximize the vast potential of a private market allocation.

Through June 2018, buyout funds in the US, Europe, and Asia-Pacific had outperformed public markets over the 1, 5, 10, and 20-year periods.¹

PRIVATE MARKET BASICS

PRIVATE VS. PUBLIC

While the differences between private and public market investing may appear obvious on the surface, there are important nuances. First and foremost, unlike public market investments, private market opportunities are not available or listed on any public exchanges, do not have publicly available pricing or valuations, and do not trade in a standardized manner. Accordingly, private fund investments are more illiquid but also afford the fund managers valuable time in which to generate returns (*see callout on p. 6*). Another key difference is that private fund investors are paid through recurring distributions over the life of the fund. It can also be challenging to get information and financial data on private companies to accurately determine their valuations. Within public markets, companies raise capital by selling shares to the general population, who in turn can buy, sell, or trade their interests on public exchanges. As such, public market investments are much more liquid and transparent.

WHAT IS PRIVATE INVESTING?

Private markets are generally accessible through private funds or direct investments into private companies. Institutional as well as individual investors supply the capital, which can be used to fund start-ups (venture capital), make acquisitions (growth equity, buyout), strengthen balance sheets (special situations), or initiate buyouts of public companies with the intent of taking them private. Investment managers, in turn, use investors' capital to buy businesses, guide them through pre-identified improvement plans, and eventually exit the investment to provide liquidity back to the original investors. In other words, buy, add value, sell.

HarbourVest's proprietary global database, built over nearly four decades, contains detailed information and key data on more than 8,500 managers and more than 30,000 individual portfolio companies.

¹ Cambridge Associates Private Investments Database, 2019

² Preqin, "The Future of Alternatives," 2018

³ Ibid

VALUE ADD: HOW PRIVATE FUND MANAGERS CREATE VALUE

Value creation is the engine that drives private market returns. Whereas public equity investing is based largely on informed insights about the future prospects of a company or market sector, private fund managers tend to engage more with their portfolio companies. Through this collaboration, they help drive future growth by providing valuable strategic and operational guidance throughout the life of the relationship – from the inside as an active owner rather than as an external passive shareholder.

Value is generally derived from three sources:



Private fund managers begin by working with the acquired company's management team to isolate key value creation opportunities and to establish incentives that ensure alignment among all stakeholders. Next is the development of an action plan addressing the company's short and long-term strategic vision through high-level improvement areas that may include:

- > Adding new capabilities (new products or brands)
- > Increasing competitiveness (operational efficiencies)
- > Growing revenues (new markets/new customers)

From here, insights are gathered on the value creation opportunities and specific target performance initiatives are established to drive toward a successful outcome.

VALUE CREATION IN ACTION

Examples of private market value creation exist all around us, from our breakfast choices in the morning to the way in which we purchase goods and services digitally. Following are two cases in which private fund managers worked closely with mature, multinational brands to transform their businesses and drive additional value.



Multinational Beverage & Food Chain

The story of this US-based company's rapid growth serves as a powerful example of how private fund managers can inject significant value into a mature, established business. Long an iconic regional brand, the company's growth trajectory had stalled in the mid-2000s and its management team felt an international expansion strategy would be the perfect antidote. The company was acquired by a consortium of private fund managers who in turn developed a value creation plan focused on expanding overseas locations, revamping the company's menu items, and investing more in customer service features such as mobile ordering and incentive programs. The company also went through a major re-branding. The restructuring has reinvigorated the company and generated strong returns for its investors.



International Payment Processing Firm

This European-based, transaction-focused company was formed in the mid-1990s just as the internet was emerging. Over the next decade its payment processing business grew rapidly as consumers became increasingly comfortable making purchases online and through mobile devices. The company was purchased by two private fund managers at a value of over \$2 billion and a strategic plan was implemented to help enhance the firm's underlying technologies and expand its products and capabilities. By 2017, backed by several profitable acquisitions, the company's value had grown to more than \$10 billion. Shortly thereafter, the company was sold for more than \$35 billion, providing a significant gain for investors that participated in the initial transaction.

CURRENT LANDSCAPE

WHY ALLOCATE TO PRIVATE MARKETS?

Non-traditional investors are gravitating to the private markets in part for the chance to generate outsized returns. Two of the top-10 companies in the world today by market capitalization – US-based Facebook and Chinese e-commerce giant Alibaba – were backed by private capital early in their development and continue to reward their investors handsomely. The potential to get in on the ground floor of deals like these is very attractive to investors.

Another key factor concerns public market returns, which have lagged private market performance in recent years. Chart 1 below shows the performance gap between private equity strategies and public equities. This comparative outperformance, combined with increased volatility and uncertainty in the public markets, continues to drive strong demand and interest in private markets.

Lastly, a more fundamental issue for public markets relates to the ongoing trend of companies staying private longer so they can build and develop their businesses away from the public spotlight. As a result, the number of publicly available investment opportunities has declined significantly over the last 20 years, while private market opportunities globally continue to be plentiful by comparison.

Alibaba was valued at just over \$167 billion when it went public. Today, the company is valued at more than \$350 billion.⁵

Facebook had only 12 million users in 2006; today it counts more than 2 billion active users globally.⁴

> Chart 1: Advantage, Private Equity

Internal Rates of Return* (as of December 31, 2018)

Private equity returns have outpaced public equity performance in recent years, driving increased demand and interest among more investors.



Source: Burgiss. *Internal rate of return (IRR) is the annual rate of return of an investment that takes both the timing and magnitude of cash flows into account. The US PE (All) return is a pooled IRR based on the combined cash flows of all private equity funds in the benchmark. The US PE (Top Quartile) return is a pooled IRR based on the combined cash flows for the private equity funds in the benchmark that achieved top-quartile performance. Public market comparison (S&P 500, MSCI Europe) provided by Burgiss and based on a methodology of buying and selling through these indices with the same timing of cash flows as the US PE (All) return. The securities comprising the public market benchmarks have substantially different characteristics than the private equity benchmarks, and the comparison is provided for illustrative purposes only. Investors should bear in mind that past performance is not necessarily indicative of future results, and there can be no assurance that future private equity investments will achieve similar results.

⁴ Facebook, The Street.com, "History of Facebook," October 2018

⁵ Bloomberg

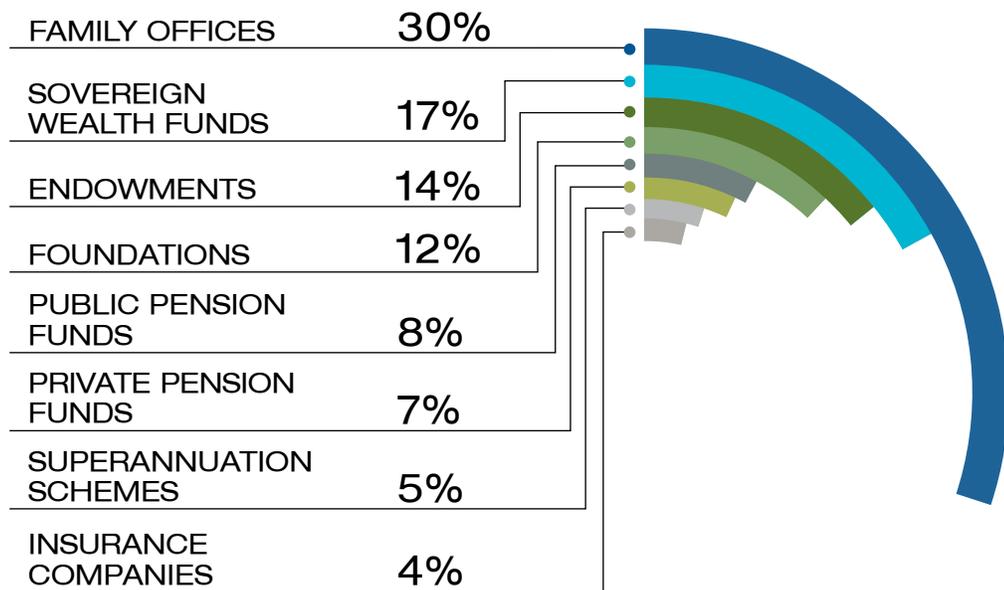
WHO'S INVESTING AND WHY?

Before 2007, private market investment consisted almost entirely of large institutions and ultra high-net-worth investors. Over the past decade, however, the mix has evolved as more investors hungry for sources of excess return have turned to the private markets (see *Chart 2*). Family offices have historically been the most active participants in the private markets, but other types of investors – including sovereign wealth funds and endowments and foundations – continue to increase their exposure.

Going forward, institutional investors expect to allocate even more capital to alternatives, including the private markets. More than half of the 230 institutions managing \$7 trillion or more in investable assets say they plan to decrease their allocation to public equities in 2019 in favor of non-traditional asset classes, up from 35% who said the same in 2018.⁶

> Chart 2: Who's Investing and Why?⁷

Average target allocation by investor type
(As proportion of assets under management)



TOP INVESTMENT OBJECTIVES



Return Potential
72%



Diversification/
Lower Correlation
33%



Risk/Volatility
Mitigation
14%

⁶ BlackRock
⁷ Preqin

ILLIQUIDITY AND THE LUXURY OF TIME

For many investors, one of the bigger obstacles to adding a private market allocation to their portfolios is their tolerance for illiquidity. Unlike public fund investing, private funds typically have fixed lives of 10 to 14 years, during which time investors' capital is locked up. In private market investing, this illiquidity is essential because it affords the manager additional time to enhance the value of the target investment, and in turn enhance investors' distributions.



For investors accustomed to ready liquidity, however, this can be a very difficult adjustment. But let's consider a hypothetical: If 2008 and the global financial crisis were to occur again, how much of your total portfolio value would you want or need to have immediate access to? While the answer of course varies on the type and size of investor, not many would want access to 100% — so there is already an inherent tolerance for illiquidity. This being the case, investors should consider allocating this smaller portion of their portfolio to private market opportunities. Doing so can allow them to benefit from the outperformance and the illiquidity premium, which only comes with this luxury of time.

THE MECHANICS OF PRIVATE INVESTING

ACCESSING OPPORTUNITIES

While investors are able to invest directly into private companies, many tend to appreciate the relative convenience of investing through commingled or multi-manager funds. These vehicles provide access to investment management expertise, but with a greatly reduced administrative burden both initially and on an ongoing basis. Additionally, investors with large private portfolios may seek customized separately managed accounts (SMAs).

> Chart 3: Comparing Access Vehicles

| | DIRECT INVESTMENTS | COMMINGLED FUNDS | MULTI-MANAGER FUNDS | SEPARATELY MANAGED ACCOUNTS |
|----------|---|--|--|--|
| What | Direct investments into portfolio companies | Professionally managed, pooled vehicles that invest in a diverse mix of private market investments | Singular vehicles that pool investors' capital and invest it with multiple fund managers | Flexible, individually managed accounts offering customized portfolio solutions |
| Features | Approach often utilized by family offices and larger institutions with in-house private market investment teams | Long-term focus with investment time horizon of 10 or more years | Higher degree of diversification; single investment allows managers to tap into portfolios of diversified assets | Clients work closely with GP to construct a portfolio tailored to meet their specific objectives |

STRUCTURES AND TERMS

Regardless of which strategies are chosen, most private market funds have similar structures, fees, and terms. These funds, however, are quite different from traditional investments such as mutual funds which reflects the unique characteristics of a private investment (see *Chart 4*).

Typically, private market funds are legally structured as limited partnerships – single entities formed by a fund manager (general partner, or GP) at the inception of a specific investment fund. The GP is responsible for the day-to-day management of the partnership and assumes full liability for its financial obligations. The investors, or limited partners (LPs), provide capital to the partnership but have no responsibility for any debt incurred beyond the committed capital, and hold no decision-making rights. Most GPs will also invest some of their own capital with that of the LP to align their interests and to benefit if the fund performs well.

Terms are mutually agreed upon and formalized through a Limited Partnership Agreement, or LPA, which defines the partnership, establishes the GP and LP roles, and sets forth investment guidelines, financial obligations and rights, and the fee structure of the fund. While a limited partnership is a closed-end vehicle with a defined life span, LPAs often include provisions allowing for extensions should a GP believe it to be appropriate.

Once an LP commits capital to a fund, it is legally obligated to provide that capital when requested through a capital call made by the GP. Since withdrawals are not possible, investors must carefully consider their liquidity requirements before committing to a private investment. For the GP, this illiquidity affords the luxury of time to be able to enter and exit investments at what it believes to be the most optimal periods. As investments mature and the value creation plan is executed, the GP will look to sell to the public markets or to a strategic acquirer to generate returns.

> Chart 4: Comparing Investment Structures and Fees

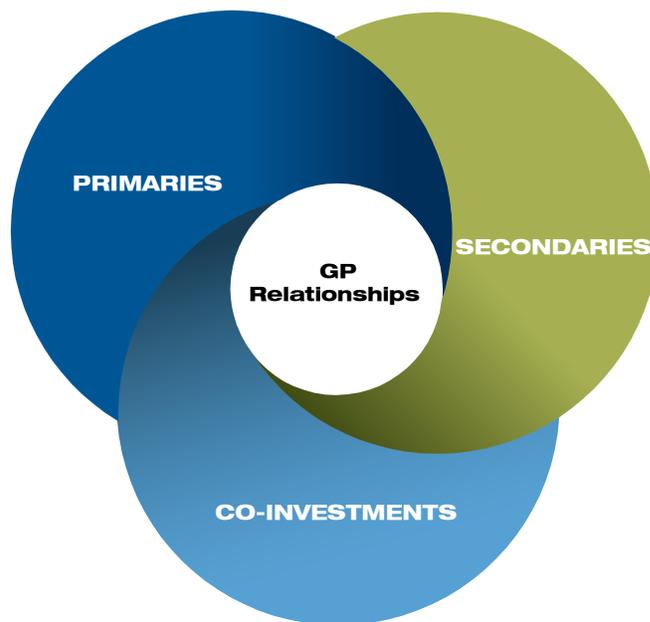
| | PRIVATE MARKET FUNDS | MUTUAL FUNDS |
|------------------------------------|--|--|
| FUND STRUCTURE | Typically closed-end limited partnerships | Typically open-ended companies |
| MANAGEMENT | Active | Active or passive |
| CAPITAL DEPLOYMENT | Capital calls to fund investments over a defined multi-year period | Typically daily subscriptions, fully funded upfront |
| CAPITAL RETURN MECHANISM | Distributions over time as investments are realized | Typically daily redemptions, paid out upon request |
| MANAGEMENT FEE | 1.25-2% annually on capital committed* | Expense ratios generally 1-1.5% annually for active equity funds |
| PERFORMANCE FEE | 15-20% of returns above a specified rate, typically 8% compounded annually | Fees generally not linked to performance |
| AVAILABILITY OF INFORMATION | Privately available | Publicly available |

Source: HarbourVest. * Rate may step down later in fund's life.

CORE INVESTMENT STRATEGIES: PRIMARIES, SECONDARIES, AND CO-INVESTMENTS

In terms of the types of private market investments, there are three main categories that comprise the vast majority of opportunities: primary investments, secondary investments, and co-investments. A well-diversified portfolio should have a balanced mix of all three, as each performs different functions that can effectively complement the others. Chart 5 provides a snapshot of each investment type as well as its distinct features.

> Chart 5: Core Investment Types



PRIMARIES

Investments in newly created closed-end primary partnerships

- Broad range of strategies
- Professional management
- Diversify by company size, trends, and geographies

SECONDARIES

Investments in existing LP interests; acquiring mature positions

- J-curve mitigation
- Near-term liquidity
- Attractive returns across cycles

CO-INVESTMENTS

Investments made directly into companies alongside private funds

- Reduced fees and expenses
- Differentiated access to top-tier managers
- Compelling risk/return profile

COMMITMENTS AND DISTRIBUTIONS

The life span of a private market fund is split into distinct periods focused on investment activity, executing the value creation strategy, and, ultimately, pursuing exits and liquidations. When a GP launches a new primary fund, it often follows a similar strategy to a previous fund that has closed or completed its investment period.

In terms of providing capital to the fund, LPs agree to a total amount of “committed capital” over the life of the fund. Commitments allocated to a fund are then drawn down on an as-needed basis to make investments, pay management fees, etc. The GP typically gives investors seven to 10 business days’ notice of a drawdown.

As the fund invests and generates profits, each investor’s share in the net proceeds is distributed in proportion to its respective capital contributions for investments, management fees, and a preferred return of typically 8% per year, compounded annually.

CASH FLOWS AND THE J-CURVE

Cash flows in private investing are very different than those on the public side; private fund managers invest capital over time and return capital incrementally as they generate proceeds. Investors therefore need to carefully manage cash flows and keep making fresh commitments to new funds.

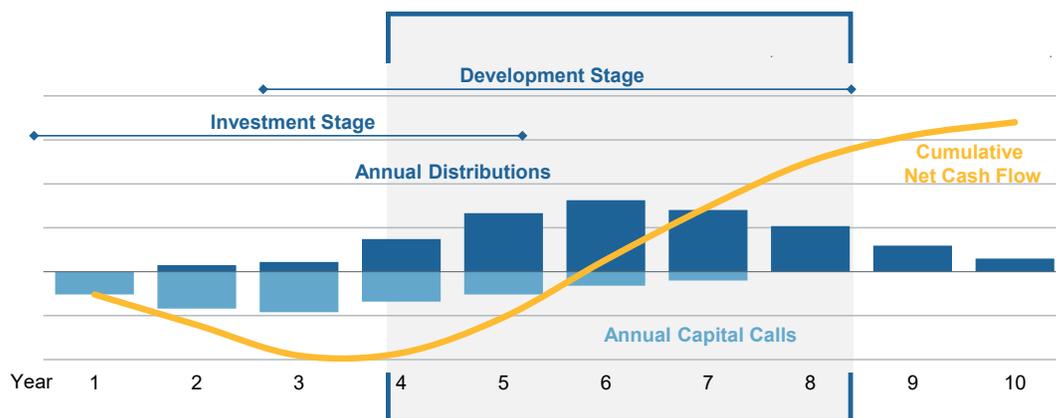
As noted earlier, the investment of the capital committed by LPs takes place over a defined investment, commitment, or drawdown period and is often legally limited to approximately four or five years following the fund's initial fundraising close, as stipulated in each specific LPA. This allows a manager to create a diversified portfolio and lessens the pressure to deploy large amounts of capital in potentially unattractive market environments.

As Chart 6 shows, the value of a private market fund across its life span often adopts a distinct “J” shape, commonly referred to as the J-curve. This simply reflects that primary funds tend to experience negative returns early on, due to upfront investment costs and the time it takes for value to be created. The internal rate of return (IRR) will therefore often fall into negative territory early on before flattening and turning positive as investments mature.

There are several strategies investors can utilize to smooth the effects of the J-curve, including:

- > Investing in secondaries, which offer accelerated investment deployment
- > Investing through a combination of private equity and private debt strategies to generate both growth and income
- > Allocating to GPs that invest in companies that are durable and growing rather than distressed
- > Investing in co-investment managers that charge fees on invested capital rather than committed capital, thereby reducing costs

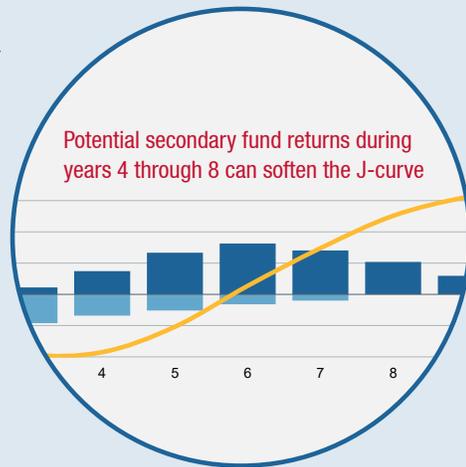
> **Chart 6: Cash Flows and the J-Curve**



This example is shown for illustrative purposes only and is intended to demonstrate the mechanics and cash flows of a private equity fund. It is not intended to predict the performance or cash flows of any specific fund and should not be construed as predicting the future. The actual pace and timing of cash flows of a private equity fund are highly dependent on the fund's investment pace, the types of investments made by the fund, and market conditions. Private equity investing involves significant risks, including loss of the entire investment.

SECONDARIES AND THE J-CURVE

While primary funds invest in “blind pools” of assets, secondary funds target more mature investments that can provide accelerated returns. These earlier returns may help reduce the J-curve effect (see *Chart 6*) typically associated with primary funds – where fund performance initially may be negative as investments are made, before turning positive later in the fund cycle as these investments begin to deliver gains. As the close-up image illustrates, this positive effect from secondary funds typically begins to occur during years four through eight in a fund’s life cycle.



CLOSING THOUGHTS

Benjamin Franklin was ahead of his time on many things, and he was spot on regarding the return on investment that knowledge can bring, particularly for investors new to the private markets.

The power of private market investing is that it allows investors to take long-term views, explore big macro themes, and position their portfolios to capitalize on future trends. However, to achieve optimal outcomes investors must commit to being engaged and informed every step of the way.

We hope this paper helps you better understand the benefits and risks of investing in private markets; the mechanics behind the process; the core strategies, structures, and transactions involved; and how your capital will ultimately be utilized and returns generated and distributed.

Part II in our educational series will focus on the key factors and considerations involved in establishing a private market program.

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