STEPSTONE

A comprehensive guide to private equity investing

AUGUST 2022

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Introduction

Private equity, in simple terms, is the investment of capital in non-public companies through privately-negotiated transactions and results in the private ownership of businesses. The industry has grown exponentially over the past 35 years and is projected to surpass $11 trillion in assets under management in 2026.[1]

While most private equity transactions involve investments in private companies, they can range from the financing of startup entities, to infusing growth equity into an expanding company, to buying out mature public or private enterprises. What is common to most private equity investments is that the investor group often acquires a large or significant ownership stake in the company through a highly structured and negotiated transaction.

Typically, private equity managers take an active role in monitoring and advising their portfolio companies. Through this "hands-on" approach, private equity managers seek to create value and enhance returns by directly influencing a company's strategy and performance, as well as the timing of the exit from the investment, whether through a sale to a strategic (e.g., a corporation) or financial buyer (e.g., another private equity firm) or via an initial public offering ("IPO").

Introduction to private equity

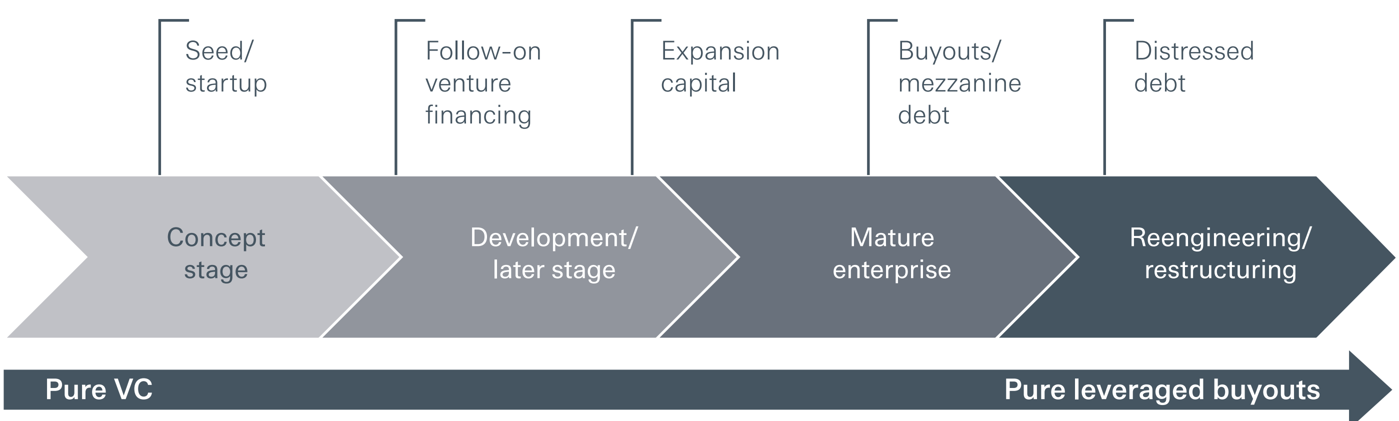
As **Figure 1** illustrates, a private equity investment can occur at virtually every stage of a company's life cycle. Four common subclasses of private equity are:

1. Venture capital
2. Leveraged buyout
3. Mezzanine debt
4. Distressed debt

VENTURE CAPITAL

Venture capital ("VC") is an important source of financing for startups, or those in the early process of developing products and services that do not yet have access to public funding by means of stock offerings or debt issues. Most VC investments are in rapidly growing companies, with a heavy concentration on the technology or life sciences sectors. There are several stages of VC investing, which often mark financial and/or operational milestones for the VC-backed company. As these companies grow and proceed from one round of financing to the next, their valuations often increase. These rounds are

FIGURE 1: THE BROAD SPECTRUM OF PRIVATE EQUITY INVESTING



Source: StepStone, March 2017.

[1] 2022 Preqin Global Private Equity Report.

often referred to as series A, B, C and so on (see **Figure 2**). Sometimes, VC investments may begin with a "seed" round, which involves initial startup capital. Generally, early-stage VC investors seek to acquire relatively large ownership interests in their portfolio companies to maximize the proceeds they receive at exit value.

Because companies in the early rounds of VC investing have higher risk profiles, their valuations tend to be lower—although the potential for significant value appreciation is higher. The risk associated with venture capital is heightened by the fact that the companies may have little or no track record. VC-backed companies may have unproven management teams and products, and may be generating very little in terms of revenues or earnings.

LEVERAGED BUYOUT

A leveraged buyout, also referred to as a "buyout" or "LBO," is a strategy that typically involves the acquisition of a relatively mature business, from either a public or private company. As the name implies, leveraged buyouts are financed with debt, commonly in the form of bank debt or high-yield bonds. Typically, these securities, especially the high-yield bond portion, are either rated below investment grade or unrated.

FIGURE 2 | STAGES OF VENTURE CAPITAL FINANCING

	Early stage "Series A"	Mid stage "Series B"	Late stage "Series C"
Management	Small number of founders, often former executives and professionals	Professional management team growing	Professional management team growing
Product and market	Concept-stage, usually only represented by a "business plan"	Working prototype or demonstrable product; "beta" tests begin with initial customers	Product in production, some key customers established
US dollars typically invested	\$3M–10M	\$5M–\$15M	>\$10M
Percentage of company acquired by new investors	20–25%	10–25%	5–15%

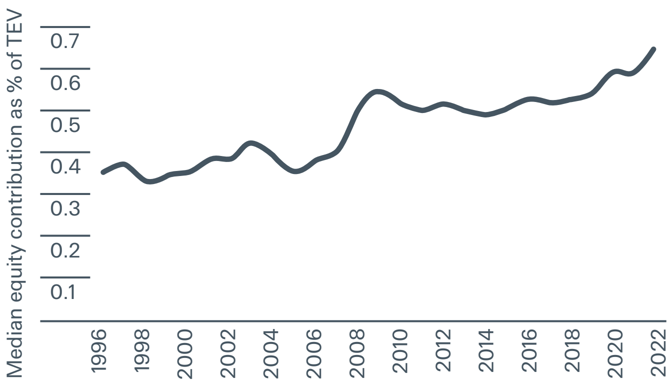
Source: StepStone analysis.

Note: The above is an illustrative example provided for information purposes only; actual venture capital financing may differ from case to case.

During the early 1990s, many LBO transactions required only 20-25% in equity to finance their purchases. By contrast, median equity contributions to LBOs have exceeded 65% in recent years (see **Figure 3**), largely due to more conservative underwriting assumptions and greater availability of equity capital.

Strategies among LBO firms can differ considerably. Some focus on consolidating large, fragmented industries. This is also known as a "buy-and-build" strategy. By contrast, other firms focus on turnaround or operational improvement situations. There are also "growth-oriented" LBO firms that will purchase unwanted business units, such as a division of a larger corporation that is deemed nonessential to the core business or parent company. With the capital investment and strategic direction that an LBO firm provides, these businesses could be revived and potentially transformed into high-growth companies. Many LBO firms employ former senior executives with significant operational experience—commonly from industries that comprise the firm's investment targets—to bring unique insight and a competitive edge to their investment decisions.

FIGURE 3: MEDIAN EQUITY CONTRIBUTIONS– ALL BUYOUTS



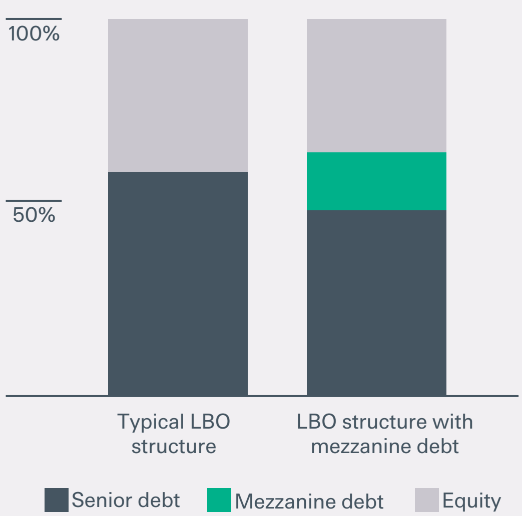
Source: Stepstone Group, 2022.
Note: Equity includes common equity and preferred stock as well as holding-company debt and seller-note proceeds downstreamed to the operating company as common equity.

Investors should be aware that buyouts have heightened investment risks, including the use of significant leverage in a portfolio company's capital structure. In addition, while the difficulties that exist in various industries and sectors may present buyout opportunities, they also present risks.

MEZZANINE DEBT

Mezzanine debt, as shown in **Figure 4**, is senior to equity but junior to senior debt on a company's balance sheet. Mezzanine financing is typically employed to help finance

FIGURE 4: MEZZANINE DEBT AND ITS CHARACTERISTICS



What is mezzanine debt?

- A middle level of financing between senior debt and common equity, e.g., convertible/subordinated debentures, structured preferred.
- Anticipated returns somewhere between senior debt and equity.
- Has characteristics of a debt instrument.

Terms	Senior debt	Mezzanine debt
Repayment	1–7 years	5–9 years
Interest	Paid regularly	Paid and/or accrued
Security	Senior	Junior/subordinated
Covenants	Tighter	Looser

Source: StepStone analysis.
Note: The above is an example provided for information purposes only; actual financing structure may differ from case to case.

leveraged buyouts when lower-cost financing alternatives, such as high-yield debt, are not available. In the US, mezzanine financing has been used mostly in middle-market buyout deals of less than US$500 million. In Europe, mezzanine debt is commonly used in companies of all sizes as the European high-yield market is less mature than its American counterpart. Mezzanine investors enjoy downside protection through the "equity cushion" beneath them.

Because mezzanine investors assume more risk than holders of senior debt, they are compensated through higher interest payments; in some cases equity kickers allow them to participate in any equity value creation. Due to the higher costs, however, mezzanine loans are typically repaid well before they mature.

The interest portion of a mezzanine security's return often comes in the form of a cash coupon or payment-in-kind interest (i.e., compound interest that is deferred until the final maturity of the loan that lets companies conserve cash flow).

As is the case with other private equity subclasses, mezzanine debt carries heightened investment risks. Notably, mezzanine investments are subordinate in priority to a company's senior indebtedness.

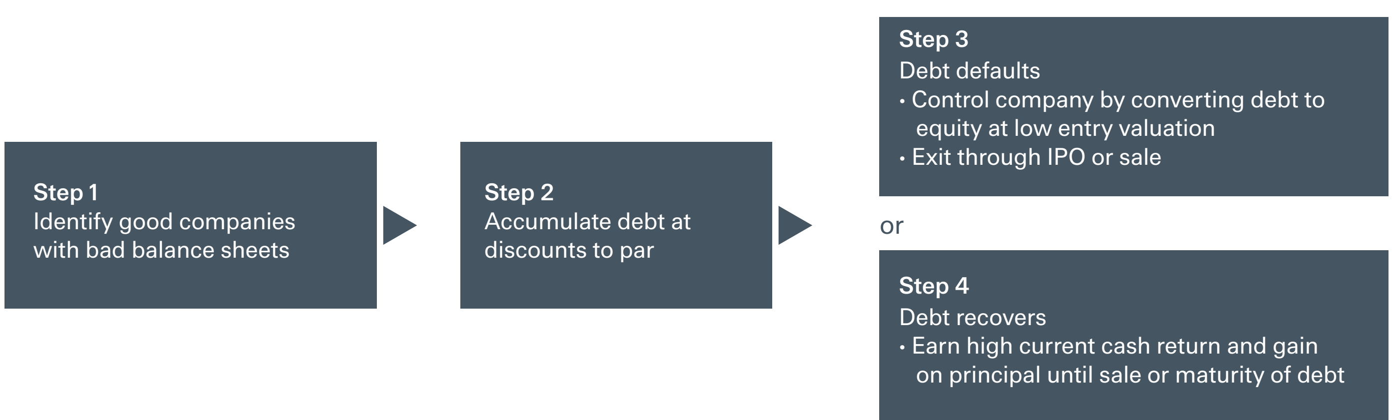
DISTRESSED DEBT

Distressed debt private equity firms typically buy corporate bonds of companies that have either filed for bankruptcy or appear likely to do so in the near future. There are two distinct strategies within distressed debt investing.

The first strategy, as illustrated in **Figure 5**, is often referred to as "debt to control," where an investor seeks to gain control of a company through a bankruptcy or reorganization process. Using this strategy, the investor first becomes a major creditor of the target company by purchasing a company's bonds or senior bank debt at steeply discounted prices. The distressed debt investor's status as creditor gives the investor the leverage needed to make or influence important decisions during the reorganization of a company—a process that may ultimately enable a company to emerge from bankruptcy protection. As part of this process, distressed debt firms will exchange the debt obligations of a company in return for newly issued equity in the reorganized company, often at very attractive valuations. This type of distressed debt investing is often used as a relatively "cheap" means of taking control of companies that have good assets, but have too much debt on their balance sheets.

The second primary distressed debt investment strategy is a trading strategy (commonly employed by hedge funds) in which an investor purchases distressed debt and seeks

FIGURE 5: HOW INVESTORS HAVE THE POTENTIAL TO PROFIT FROM DISTRESSED DEBT INVESTING



Source: StepStone analysis.

to profit as the underlying company recovers and its debt appreciates. This strategy hinges on the investor's ability to identify companies that are currently in financial distress, but look likely to recover in the near future.

Not surprisingly, distressed debt investing is highly cyclical. A weak economy usually leads to increased corporate default rates and financially distressed companies, creating robust opportunities for distressed debt investors. Conversely, periods of stronger economic growth tend to provide fewer investment opportunities. In addition to risk from economic cycles, distressed debt is characterized by heightened risk due to uncertainties that may surround businesses emerging from a bankruptcy process. Furthermore, the bankruptcy or reorganization process is highly complex and time-intensive: an investment's value can be impaired quickly if the manager miscalculates or unforeseen circumstances arise.

Why invest?

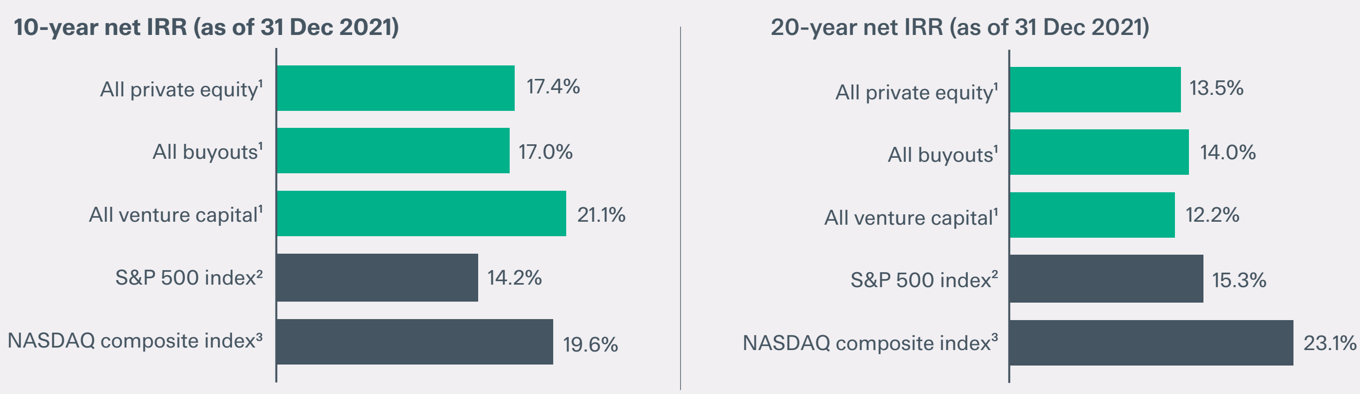
Private equity investments can provide sophisticated and experienced investors with an appealing complement to more traditional equity and fixed-income portfolios. In fact, private equity has historically outperformed the public equity markets and can provide access to unique opportunities that are only available in the private market.

Notwithstanding these advantages, however, investors should be aware that private equity investments carry heightened risks, which are explained in greater detail later in this piece.

POTENTIAL FOR ABOVE-AVERAGE RETURNS

Generally, the private market nature of private equity enables investors to invest at prices lower than those of public market transactions. As these companies mature or improve their operations, their value may increase as well. Investors are rewarded for the value created in a private transaction when a private investment culminates in a public market transaction (e.g., an IPO) or is sold at a higher value in a merger and acquisition ("M&A") transaction. As illustrated in **Figure 6**, private equity has generated attractive returns, at times eclipsing those generated in the public markets. These performance figures are merely averages, and performance for

FIGURE 6: PUBLIC VERSUS PRIVATE MARKET RETURNS OVER 10- AND 20-YEAR PERIODS



Source: StepStone Portfolio Analytics and Reporting; Yahoo Finance.
Note: Past performance is no guarantee of future results; real results may vary. Investors cannot invest in an index.
[1] "All Private Equity," as defined by ThomsonOne, is a composite of returns that includes venture capital, buyouts and mezzanine funds, the last of which is not a significant component; "All Buyouts" includes small, medium, large and mega-buyouts; "All Venture Capital" includes early, seed and later stages.
[2] The S&P 500 Index is an unmanaged stock index composed of primarily large capitalization companies; investing in the S&P 500 Index is subject to the general risks of the equity investing, which include, among others, market risk and the volatility of returns.
[3] The NASDAQ Composite Index is an unmanaged stock index with an emphasis on technology-oriented companies; investing in the NASDAQ Composite Index is subject to the general risks of the equity investing, which include, among others, market risk and the volatility of returns.

top-quartile managers can be significantly higher. As discussed later, there is a substantial spread between top and average managers in private equity. However, past performance is, of course, no guarantee of future results and real results may vary. In addition, private equity investments involve substantial risks that are not associated with investments in the S&P 500 Index or NASDAQ Composite Index, such as illiquidity and difficulties accessing current valuations.

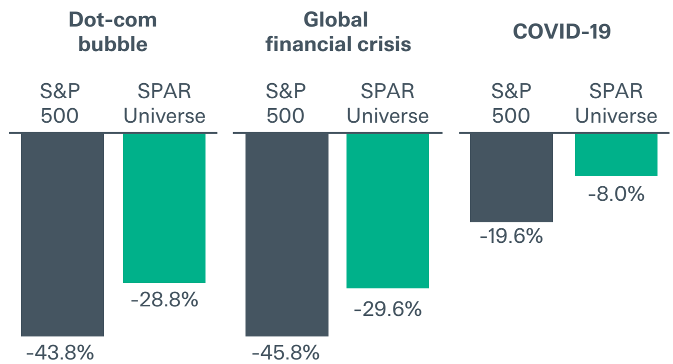
DOWN-MARKET CAPTURE

Figure 6 shows that private equity captures a substantial portion of market growth (so-called up-market capture). But increasingly, investors have come to appreciate another benefit of private equity: downside protection, or down-market capture. **Figure 7** illustrates that during the recent Covid-induced downturn, private equity valuations fell by 8% on average; public market values, on the other hand, fell by 20%. This phenomenon is also apparent in other downturns including the global financial crisis and the dot-com bubble. Private equity has only captured 60% of market downside historically.

DIVERSIFICATION AND ACCESS TO UNIQUE OPPORTUNITIES

Although private equity performance has some correlation to public market performance, investing in private equity provides exposure to asset classes that are different from traditional stock and bond investments. Individuals who invest in private equity often have access to segments of the market that others do not. For example, the most innovative ideas and companies, often with the highest return potential (and the highest investment risk), can be found within the VC sector, which offers investors the opportunity to fund companies that are on the cutting edge of the technology, health care

FIGURE 7: PUBLIC VS PRIVATE MARKET PEAKS TO TROUGHS



Source: CapIQ, StepStone SPAR Analytics, as of June 2022. Downside is defined as the max drawdown between the peak and trough during a crisis. Dot-com peak 3/31/2000, trough 9/30/2002; GFC peak 9/30/2007, trough 3/31/2009; COVID peak 12/31/2019, through 3/31/2020; Post-COVID peak 09/30/2021.

or energy sectors. Buyouts afford investors opportunities to participate in the transformation of out-of-favor companies or corporate divisions that have the potential to increase in value when nurtured with substantial financial and strategic effort. Because most public companies are constantly under pressure to meet their quarterly financial targets, which can conflict with longer-term business building, these transformations most often occur in the private market.

Private equity investors may also be afforded attractive opportunities in distressed debt purchases or by the outright purchase of distressed assets. Navigating the distressed segment of the market entails knowledge of complex bankruptcy law and of how and where to acquire such assets. High-quality managers have the expertise, time and resources needed to make such investments.

POTENTIAL TAX ADVANTAGES

In addition to the benefits of diversification and potentially higher risk-adjusted returns, private equity investors domiciled in the US may also enjoy tax advantages, because most of the gains generated by private equity funds are long term in nature and are taxed at a more favorable rate. Gains, losses, income and expenses are passed through a private equity partnership to each individual investor; but the tax deductibility of certain investment expenses is subject to various income limitations.

Key success factors

MANAGER SELECTION

In our opinion, manager selection is atop the list of what we consider key success factors for private equity investing. When investors commit to a private equity fund, they are essentially committing to a team of professionals because, in many cases, private equity investing is "blind-pool" investing.

While selecting what we consider the best firms to invest with is a challenge, the rewards can be substantial. **Figure 8** compares returns in the public and private marketplace. Over the 14 year period ending in 2020, the average annual spread between top quartile and median quartile returns for US private equity funds was 11.59%. By contrast, the corresponding spread for the domestic stock funds over the same period was only 1.81%. The top-median quartile spread is more than six times greater for private equity versus public mutual funds. In other words, the difference in performance between a top manager and an average manager is six times greater among the universe of private equity managers versus public equity managers. The comparison is just as startling when we look at the top-bottom quartile spreads: a 21.96% annual spread for US private equity versus only 3.24% for US stock funds. European private equity spreads are also wide. Given the high "value-added" component of private equity investing, coupled with the inefficiencies of the private equity market, it is not surprising that the dispersion of fund returns is very wide.

FIGURE 8: ANNUALIZED TRAILING 15-YEAR RETURNS 1 JULY 2006 – 31 DECEMBER 2020 (%)

Net return to limited partners	All US private equity[1]	US stock funds[2]	All European private equity[1]	European stock funds[2]
Top quartile	23.93	10.78	19.64	6.79
Median quartile	12.34	8.97	10.64	5.4
Bottom quartile	1.97	7.54	1.2	4.73
Spread (top-median)	11.59	1.81	9	2.06
Spread (top-bottom)	21.96	3.24	18.44	3.1

Source: Private iQ, Morningstar.
Note: Past performance is no guarantee of future results; real results may vary; there can be no assurance that any investments to be made will produce comparable, or any, investment returns.
[1] Percentile results are calculated using linear approximation based on the array of individual fund results. Linear interpolation is then used to approximate the defined percentiles of 5th, 25th, 50th, 75th and 95th by using the actual ranks for each fund.
[2] Percentile results are calculated using linear approximation based on the array of individual fund results. Linear interpolation is then used to approximate the defined percentiles of 5th, 25th, 50th, 75th and 95th by using the actual ranks for each fund.

Private equity managers with access to the best resources, information and professionals are at a clear advantage. Often, these managers established their franchises through years of experience over multiple economic and capital market cycles. Many of the top-tier private equity firms are the ones that have been in business for several decades and have built up a solid track record.

DIVERSIFICATION[2]

We believe that creating an appropriate private equity portfolio involves spreading risk across multiple parameters, while seeking to enhance potential returns. Diversification can be by development stage (e.g., VC, growth and buyout) as well as by industry focus, geography, investment manager and vintage year.

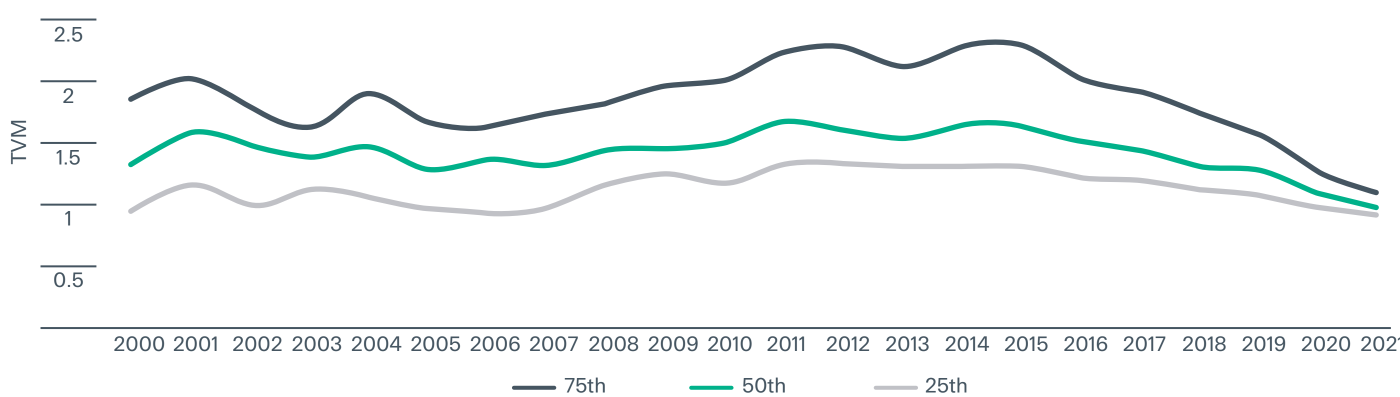
Figure 9 illustrates the importance of vintage diversification within private equity. Timing the market in private equity is very difficult and not something that is recommended. Given the longer-term nature of the asset class, a private equity commitment made in any particular year (i.e., "vintage") will strongly be influenced by prevailing economic and capital markets conditions over a subsequent five to ten year period, which is difficult, if not impossible, to accurately predict. Many investors seek to build portfolios that are diversified by vintage to smooth out future returns and not unduly concentrate risk in any one vintage.

Size of the market

FUNDRAISING

In the early 1970s, only a handful of firms raised private equity funds. Today, there are more than a thousand active private equity firms.[3] Driven by past strong performance, dollar inflows into private equity have historically achieved high growth

FIGURE 9: TVM QUARTILES BY FUND VINTAGE



Source: StepStone Portfolio Analytics and Reporting as of March 31, 2022. SPAR data are updated continually; historical values subject to change. Note: Past performance is no guarantee of future results, real results may vary, there can be no assurance that any investments to be made will produce comparable, or any, investment returns.

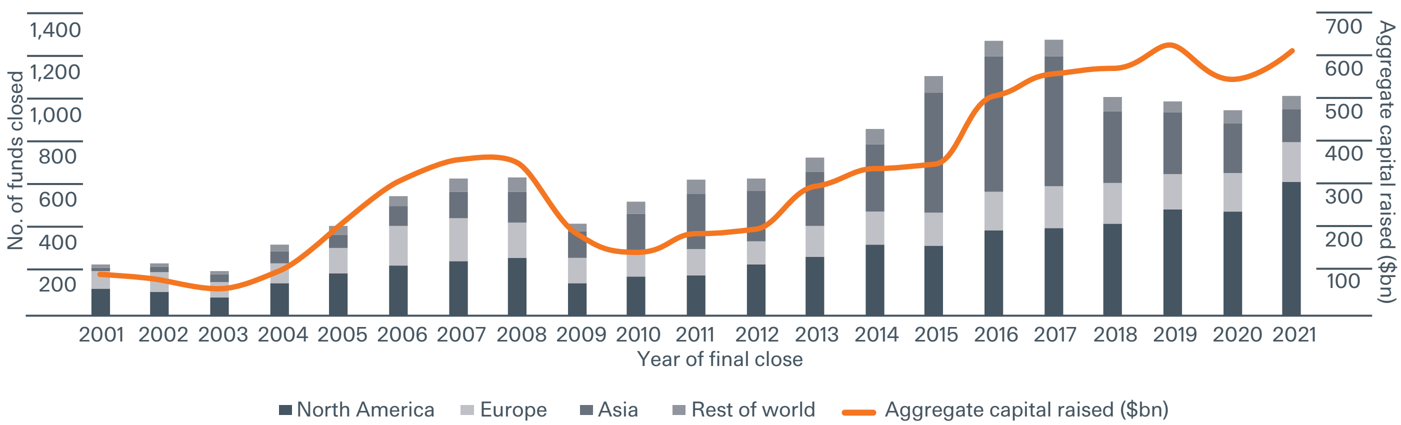
[2] Diversification does not assure a profit or protect against a loss.

[3] StepStone Private Markets Intelligence. StepStone data are updated continually; historical values subject to change.

rates. As **Figure 10** illustrates, fundraising has increased consistently in the past ten years, with the single downturn in 2020 a consequence of Covid's interruption. While the trend is upward, there is some cyclicality to it based on when managers bring funds to market (a manager generally raises new funds every few years) as well as general market conditions.

Private equity continues to play an important role in the global economy and financial markets. Firms have increasingly cast a wider net with regard to investor location: **Figure 11** shows that the proportion of Asian investors has increased over the past several years; however, as a result of the Covid-induced downturn, private equity managers have targeted fewer deals in emerging markets. In addition, the number and caliber of top executives that have made the jump to private equity is another sign of the growing influence of the asset class. Beyond top executives, millions of employees work for private equity-backed companies worldwide, including such well-known corporations as SpaceX and Four Seasons Hotels and Resorts. We expect private equity will continue to influence the economy and financial markets.

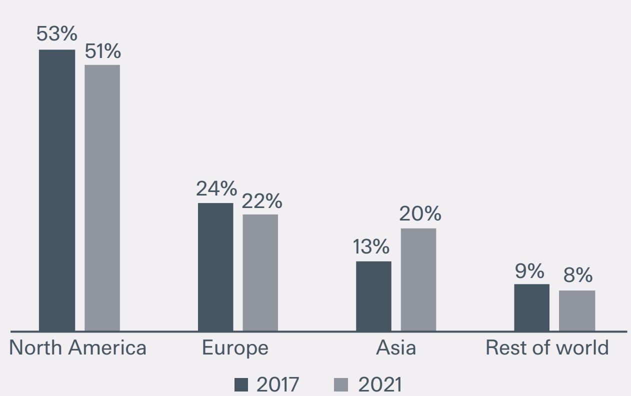
FIGURE 10: GLOBAL PRIVATE EQUITY FUNDRAISING



Source: Preqin Pro. Preqin data are updated continually; historical values subject to change.
Note: Past performance is no guarantee of future results, real results may vary, there can be no assurance that any investments to be made will produce comparable, or any, investment returns.

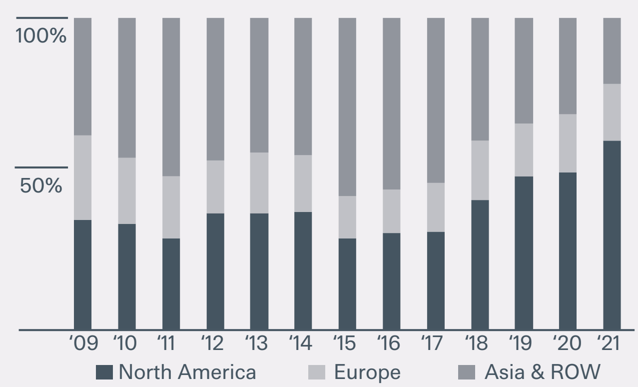
FIGURE 11: GLOBAL LBO TRENDS

Active investors in private equity by location, 2017 vs. 2021



Source: Preqin Global Private Equity & Venture Capital Report.

LBO deals by target region



Source: Preqin Global Private Equity & Venture Capital Report.

WHO INVESTS IN PRIVATE EQUITY

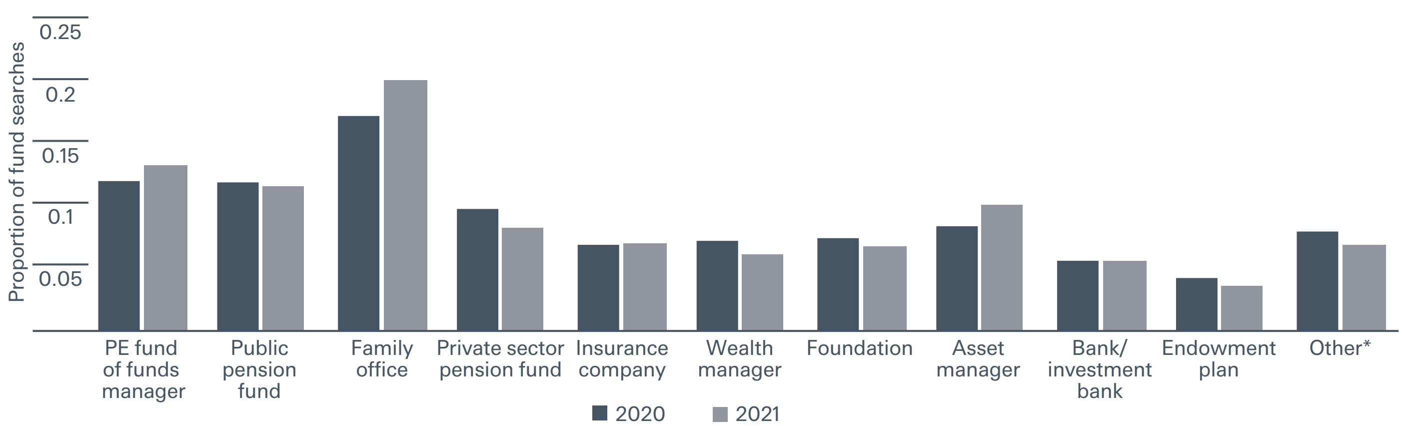
As seen in **Figure 12**, a diverse array of institutions invest in private equity. The amount each invests depends on several factors including its risk-return objectives and liquidity needs. Family offices accounted for the greatest proportion of manager searches in 2021 followed by fund-of-fund managers. Although institutions, in aggregate, still account for the bulk of private equity capital invested today, private equity has become more accessible to individual investors through the creation of vehicles offering access at lower minimums. As a result, high net worth investor participation rates have grown significantly over time.

Qualified, sophisticated and experienced individuals can access a variety of private equity strategies at lower minimums, while still benefiting from professional manager selection, fund administration and ongoing monitoring and reporting. Since 2017, the private equity investor base has seen a 17% increase led by corporate investors and private sector pension funds. In 2022, 91% of investors surveyed expect to allocate the same or more capital to the private equity market in the coming year.[4]

Drivers of returns

Private equity investments are distinct from public equities along a number of dimensions, many of which are arguably drivers of enhanced private equity returns. Investors in privately held companies might benefit from conducting detailed due diligence, entering at more attractive valuations, obtaining active management or control of the investment,

FIGURE 12 | PRIVATE EQUITY MANDATES ISSUED BY INVESTOR TYPE, 2020 VS 2021



Source: 2022 Preqin Global Private Equity Report.

[4] 2022 Preqin Global Private Equity Report.

taking a long-term view of investing and using leverage efficiently (see **Figure 13**).

IN-DEPTH DUE DILIGENCE

Determining the value potential of a private equity investment is a critical process for investors, and can take months or even years. During the due diligence period, a private equity manager often has broad access to a company's financial records, strategies and management team. This level of detail and access to information is not typically available to public market investors. In addition, a private equity manager often employs the expertise of accounting and consulting firms to evaluate target companies. This process often includes intensive interaction with customers, suppliers and management. The level of due diligence in a private equity investment often cannot be replicated by public market investors, who typically do not have the time, resources or access rights to obtain similar information. Such rigorous discipline enhances the chances for successful investment decisions.

INFLUENTIAL HANDS-ON INVESTING

Most private equity investors are highly involved with the companies in their portfolios, and often have significant influence, if not full control, over the operations and finances of their portfolio companies. They often assert their control through board seats and senior management appointments. In some cases they may even act as a company's CEO or chairman. Private equity investors can also provide capital markets and industry expertise. Finally, private equity managers seek to maximize investment value by controlling exits and determining the appropriate timing and structure of liquidity events.

FIGURE 13 | STRUCTURAL ADVANTAGES OF PRIVATE EQUITY VERSUS PUBLIC EQUITY

	Private equity	Public equity
Due diligence	Access to proprietary information	Access to public filings
Portfolio company capital structure	Optimized for particular company and situation	Subject to public market norms, which can change based on prevailing sentiment
Control of investment	Typically full control or significant influence; hands-on, activist investing, heavy board involvement	Proxy voting
Investor value-added capabilities	Access to resources such as capital markets expertise, industry contacts, senior management recruiting and growth capital	Typically passive investing, although larger institutional shareholders can exert influence
Time horizon	Commitment to long-term value creation, no public market pressure	Short-term pressure to meet quarterly earnings can compromise long-term goals
Exit options	IPO, M&A, dividend recapitalization, secondary (fund-to-fund) transactions	Sell at market

Source: StepStone analysis.

MANAGING FOR LONG-TERM VALUE CREATION

Private equity-backed companies enjoy the benefit of being able to adopt a long-term view of managing their business versus meeting quarterly earnings expectations set by the Wall Street community—a pressure that might drive public companies to focus on short-term objectives at the potential cost of long-term goals. This is especially relevant in today's environment of increased regulation and growing demands from activist investors such as hedge funds. Likewise, private equity-backed companies can often avoid the increased costs and complications of the regulatory compliance, focusing instead on long-term growth.

PROPERLY "INCENTIVIZED" MANAGEMENT TEAMS

To create optimal value in the underlying portfolio companies, it is essential that the interests of the private equity manager and the company management are aligned. To promote such alignment, private equity firms often provide financial incentives to the portfolio company's senior management team through stock ownership and by tying compensation to performance. The senior management team of a private equity portfolio company typically will own anywhere from 5%-10% of the company. This can translate into a substantial wealth creation opportunity for management, but only if management increases the value of the portfolio company.

OPTIMAL CAPITAL STRUCTURES

Private equity firms may also be able to use leverage more effectively than public companies. Private companies have more flexibility to change their capital structures (e.g., the mix of debt and equity securities to finance a company), as public companies often have to conform to what the public markets consider generally acceptable in terms of the amount and structure of leverage.

MULTIPLE EXIT OPTIONS

Private equity funds can "realize" or "exit" (i.e., monetize or liquidate) their investments through a variety of means. IPOs, strategic sales, sales to other financial sponsors or dividend recapitalizations are some of the more common methods. Having multiple exit options gives private equity funds a choice of means by which they seek to maximize value. Multiple exit options also help when certain parts of the capital markets become difficult to access. For example, private equity investors may seek liquidity through a dividend recapitalization when IPO markets are weak. By contrast, investors in public securities typically have only one option to realize their investment: selling at the prevailing market price.

In addition to the beneficial qualities of private equity investing, there are also risk considerations that investors should review before making an investment. A summary of these risk considerations follows.

Risk considerations

An investment in a private equity fund can involve a high degree of risk. Investors are advised to refer to the confidential private placement memorandum for the specific fund under consideration for a more complete assessment of the risks involved in an investment. These risks may include:

1. Long-duration, illiquid asset class
2. Valuation
3. Speculative investment
4. Commitments to managers are long-term and binding
5. Default remedies
6. "Blind-pool" investing
7. Access to timely information
8. Schedule K-1 statements

LONG-DURATION, ILLIQUID ASSET CLASS

Private equity strategies are generally long-term illiquid investments with no organized exchange or public market. Partnerships can last 10-15 years. Unlike common stock in a publicly held corporation, investors cannot readily liquidate private equity investments.

Furthermore, the secondary market for these types of investments is often limited, and secondary bids for partnership units may occur at steep discounts to reported net asset values. Many of the advantages of private equity can only be exploited over time. Investors in the asset class should be able and willing to make a long-term commitment to reap the rewards of their investment.

VALUATION

As private equity funds generally will invest in securities that are not readily marketable, the current fair market values are very often difficult to ascertain. The industry has evolved significantly over the past several years following the requirements laid out by the Financial Accounting Standards Board ("FASB"). Beginning in 2007, financial statements had to reflect the "fair value" of assets as of the reporting date. The fair value was defined within FASB literature as the price at which a willing buyer and a willing seller would conduct a transaction for the asset. Even with the additional requirements, determining fair value is subjective, and general partners may often take different approaches to estimate it. However, through demands from the investor base and industry pressure, the transparency and disclosure around fair value is much improved from years past.

SPECULATIVE INVESTMENT

The investment strategies used may include highly speculative investment techniques, highly concentrated portfolios, control and non-control positions and illiquid investments. Because of the specialized nature of private equity, the investment is not suitable for certain investors, and, in any event, an investment in a private equity fund should constitute only a limited part of an investor's total portfolio. There can be no assurance that a private equity investment will return investors' capital or that cash will be available for distributions.

COMMITMENTS TO MANAGERS ARE LONG-TERM AND BINDING

Once a commitment is made to a private equity manager, that commitment is legally binding through the terms of the limited partnership agreement. Even if a fund manager is performing poorly, limited partners must still honor their capital commitments. Limited partners in a fund generally cannot fire or replace a manager who is performing poorly, and their recourse may be limited. When managers are performing poorly or are not investing in accordance with their stated strategy, investors may seek to influence the fund's investment strategy and direction through ongoing dialogues, organized forums such as fund advisory boards and/or their contractual rights as outlined by the limited partnership agreement of the particular fund. Nonetheless, this can be a difficult process. The difficulty or inability of investors to replace underperforming managers underscores how important it is for investors and advisers alike to perform comprehensive manager due diligence before investing.

DEFAULT REMEDIES

If an investor fails to fund a capital call from a private equity fund, the fund may exercise various remedies with respect to such an investor and its interest. These remedies include, but are not limited to, causing the investor to forfeit or sell all or a portion of its interest in such fund, or requiring the investor to pay up to the full amount of its remaining capital commitment.

"BLIND-POOL" INVESTING

When committing to a private equity fund, an investor is essentially committing to a team of professionals, since in many cases private equity is "blind-pool" investing (i.e., the investor does not know the composition of the portfolio because funds are raised first and thereafter invested in portfolio companies). "Blind-pool" investing underscores the importance of conducting thorough and rigorous manager due diligence before making an investment.

ACCESS TO TIMELY INFORMATION

Typically, a three-month time lag may occur between the end of a quarter and when investors in a private equity fund receive their quarterly report. This time lag is primarily a result of the number of discrete portfolio companies in which a manager invests and the associated financial reporting that goes along with each investment.

In certain cases, depending on the policy of the individual manager, it may be difficult to obtain detailed financial information for individual portfolio holdings. Many private equity firms believe in closely guarding the confidentiality of their investments. If certain sensitive financial information were made broadly available, it could put their portfolio companies at a competitive disadvantage.

SCHEDULE K-1 STATEMENTS

IRS Schedule K-1 statements provide the information that taxable US investors need to file their personal tax returns. Given the number of underlying portfolio investments and the complexity involved in preparing these tax schedules, Schedule K-1 statements are likely to be received by investors after the April 15 tax-filing deadline. Therefore, it is not uncommon for investors in private equity partnerships to have to file for an extension. In addition, depending on the structure of certain investments within the partnership, the potential exists for multi-state tax filings for investors. Some fund managers (especially funds of funds) will provide tax projections to investors in advance of Schedule K-1 statements, to assist with tax planning.

Assessing performance

Two metrics are typically used to assess the performance of private equity investments: the internal rate of return ("IRR") and the cash on cash return multiple. Strictly defined, the IRR is the discount rate that sets the net present value of a series of cash flows equal to zero. It is perhaps the most widely used performance measurement tool for private equity. By contrast, the return multiple looks at the ratio of the money returned to money invested. For example, $1 invested in a private equity fund that generates $2.50 in distributions implies a 2.5 times return multiple. There are pros and cons associated with using each metric, as we will explain.

INTERNAL RATE OF RETURN[5]

Using an IRR allows investors to measure the performance of a series of periodic uneven positive and negative cash flows. This feature is especially relevant in the context of private equity investing, because capital is drawn down and invested over time (negative cash flows) with distributions paid out over time (positive cash flows). This contrasts with many traditional investments that consist of one lump-sum investment and one cash-out, which tends to make performance calculations much simpler. Despite its advantages, the IRR does have several drawbacks.

- It places too much weight on investments that return capital after short investment periods, even if the absolute dollar returns lag behind those of their peers. This tendency was most evident in the fevered VC market of the late 1990s, when companies progressed from startup to IPO in record time, generating high initial IRRs for many venture funds.
- Another drawback is the lack of an industry standard in computing IRRs. Different private equity firms may use slightly different methodologies in computing their investments' IRRs. Even a small change in the methodology can have a dramatic impact on the results.

[5] Please see the definition of "internal rate of return" in the glossary for a brief description of the various calculation methodologies.

RETURN MULTIPLE

As an alternative to the IRR, the return multiple corrects one of the main IRR drawbacks: placing too much weight on early distributions. Return multiples are simply a calculation of the monies invested versus the monies returned, which is not sensitive to the timing of distributions. In addition, by using the return multiple, investors do not need to concern themselves with the various subtleties and differences in IRR computations among different firms or investments.

However, the return multiple also has a drawback: it fails to take into account a basic premise of investing—the time value of money, or the fact that a dollar today is worth more than a dollar tomorrow due to inflation and the opportunity cost of tying up capital in investments.

INTERPRETING PRIVATE EQUITY PERFORMANCE

We think it is prudent for investors to use both the IRR and return multiple together in evaluating performance. A high IRR generated by "quick hits" is not typically a sustainable investment strategy that produces long-term wealth. Similarly, a high return multiple is not attractive if it takes an undue amount of time to generate. Striking a balance between the two metrics may be a sensible way to think about performance measurement.

In **Figure 14**, an investor who evaluated the two sample investments strictly on the basis of their IRRs would prefer Investment A to Investment B. However, on closer examination, Investment B generates 100% more "cash profit" than Investment A (i.e., a return multiple of 2.0 times versus a return multiple of 1.5 times), even though Investment B's IRR is five percentage points lower.

In our view, neither investment is technically "better" than the other: selecting between the two choices may depend on an investor's personal circumstances and access to other opportunities. For example, an investor who had continuous access to fast-returning investments might prefer Investment A so that the proceeds could be reinvested quickly into other high-returning opportunities. But, if not, Investment B might be more attractive, its lower IRR notwithstanding.

UNDERSTANDING QUARTERLY PERFORMANCE

When investors analyze interim valuations and performance, they need to consider factors other than the nuances of valuation metrics. Given that private equity is by nature a long-term, illiquid asset class, interim valuations may not be that meaningful, especially in forecasting long-term performance. Additionally, many private equity firms have different valuation methodologies that can affect interim performance reporting.

FIGURE 14: ANNUAL IRR VERSUS RETURN MULTIPLE COMPARISON

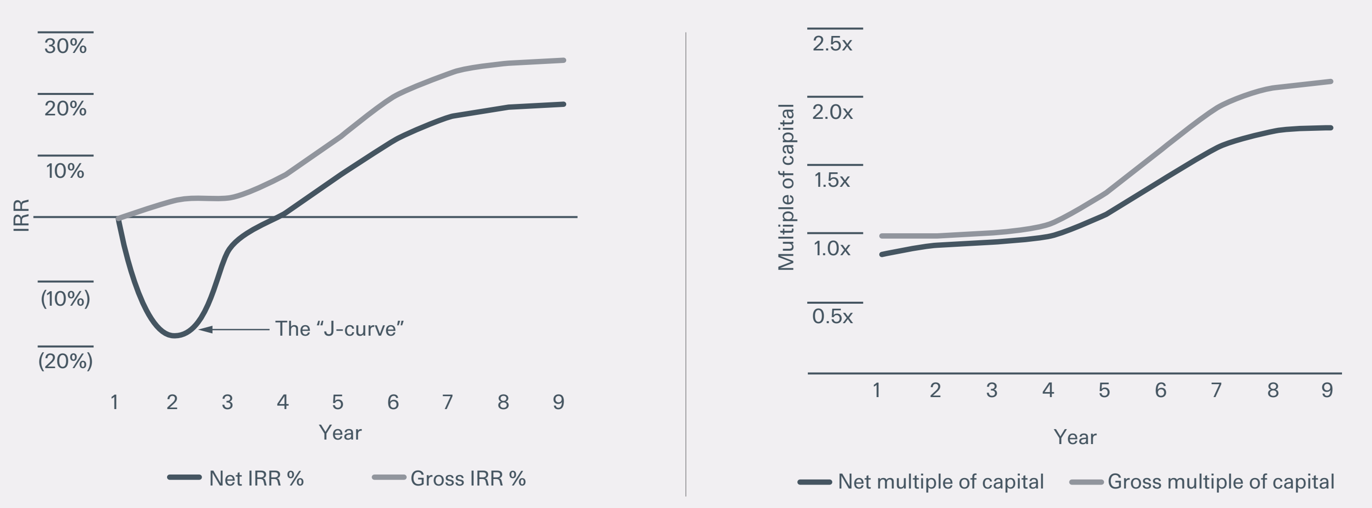
Total investment Years	$100 1	2	3	4	5	Annual IRR	Return multiple
Cash flows							
Investment A	($25)	($75)	$145	$0	$5	36%	1.5x
Investment B	($50)	($50)	$75	$25	$100	31%	2.0x

Source: StepStone analysis.
Note: For illustrative purposes only; past performance is no guarantee of future results; real results may vary; the cash flows and performance of an actual private equity fund investment will differ from that which is shown above.

In our opinion, when reading quarterly reports, especially early on in the life of a fund, investors should focus on understanding qualitative items such as the investment pace and industry or sector focus of the fund. For example, if capital is being deployed rapidly, it could mean that the fund is too aggressively chasing deals and could be susceptible to valuation trends over a narrow period of time. Alternatively, rapid capital deployment could be prudent given the nature of a fund, its strategy and the quality of its investments. Therefore, it is important to try to understand what is driving the investment pace. Paying close attention to the sectors in which capital is being invested will help an investor understand industry trends and which sectors will drive performance for a fund.

It is also important to note that during the early years of a fund's existence, it will show a decrease in value (i.e., a value less than 100% of contributed capital). Part of this decline can be attributed to how management fees are computed. Management fees are calculated on committed capital rather than invested capital. This magnifies the fee drag on performance early on in the life of a fund, with typically few offsetting investment valuation increases or positive realizations early in the investment cycle. Furthermore, write-downs and write-offs may occur early on in the life of a fund, as losing investments are identified, while many of the remaining investments are held at cost, even if performing ahead of schedule. The combination of fee drag and potential write-downs early on in the life of a fund is commonly referred to as the "J-curve" of performance, since early on, the performance pattern of a typical private equity fund resembles the letter "J" (see **Figure 15**). In the middle years of a fund's life (typically years three to four), when realizations are beginning to occur or certain unrealized investments are potentially written up, the fund's value may begin to rise (i.e., to a value greater than 100% of contributed capital). As previously stated, private equity is not an asset class that typically generates meaningful interim performance, especially early on in the fund's existence, but rather a long-term asset class that is best evaluated over the entire period of the life of a fund. As a fund matures and investments are realized, a closer examination of the fund's net asset value, distribution information and performance metrics will become more meaningful.

FIGURE 15: TYPICAL PRIVATE EQUITY INVESTMENT CYCLE (IRR AND MULTIPLE OF CAPITAL)



Source: StepStone analysis.
Note: For illustrative purposes only; past performance is no guarantee of future results, real results may vary.
The cash flows and performance of an actual private equity fund investment will differ from that which is shown above.
These charts use the following assumptions: capital invested over four years (predominantly in years two and three) of the partnership; annual fees of 1.75%; carried interest of 20%; realizations beginning in year five (predominantly three to four years after the specific investment was made); and a gross IRR of 25%; performance calculations based on mid-year convention.

The charts in **Figure 15** depict two key metrics that have generally been used to evaluate private equity performance: IRR and return multiples, also called multiple of capital or "MOC." The first chart illustrates the "J-curve" effect as it relates to IRR. As shown, the disparity between gross and net returns early on in the fund's life is dramatically affected by factors such as fee drag. As discussed previously, IRRs are very sensitive to the timing of cash flows. Over time, gross and net IRRs will converge as more capital is invested and returns are realized, thus diluting the disproportionate impact of fees and potential writedowns on the IRR early in the life of a fund.

The second chart depicts gross and net MOC, which conversely do not converge over time, but rather tend to diverge. While MOC is typically low or negative in the early years of a fund, the spread between gross and net MOC is not as pronounced as the spread between gross and net IRR. Unlike IRRs, return multiple computations do not take into account any time element in their calculation and therefore are less sensitive to the impact of fees in the early stages. However, MOC is more sensitive to the magnitude of fees or carried interest compared to the timing of these cash flows. Carried interest, which is the profit incentive a private equity manager potentially earns, occurs as investments are realized, causing gross and net MOCs to diverge over time. Although carried interest also affects the IRR, it tends to be more "back-end" weighted in the life of a fund and occurs as profits are realized and therefore tends not to have as dramatic of an impact in the variance between gross and net IRRs as management fees can have early on.

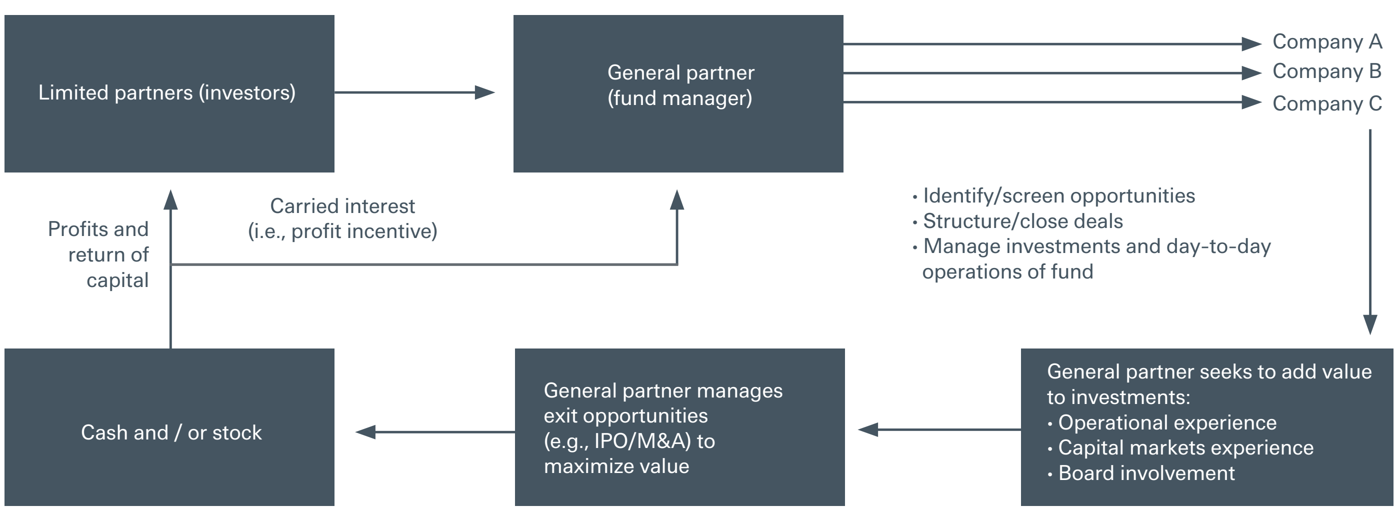
The mechanics of investing

The mechanics of private equity investing are illustrated in **Figure 16**. Most private equity investors[6] access the asset class through capital commitments to private equity limited partnerships. These limited partnerships then make direct investments in companies or funds (e.g., funds of funds).

GENERAL PARTNER/LIMITED PARTNER RELATIONSHIP

The manager of a partnership is called the "general partner," while the individuals and institutional investors who provide the majority of the capital are called the "limited partners."

FIGURE 16: HOW A PRIVATE EQUITY PARTNERSHIP WORKS



[6] To invest in private equity, a US citizen generally must be a Qualified and Accredited Investor. Qualified Purchasers include individuals and family entities with minimum net investment assets of $5 million or other entities with minimum net investment assets of $25 million (e.g., corporations, public foundations and endowments). An individual Accredited Investor must have a minimum net worth of $1 million or a gross income in excess of $200,000 (or joint income with the investor's spouse in excess of $300,000) in each of the two previous years and must reasonably expect to maintain that level of income for the current year. An entity Accredited Investor generally must have total assets of $5 million or more.

Typically, the general partner will also contribute at least 1% of total commitments raised to the partnership, and principals of the firm may also invest additional personal capital in the fund. The general partner is responsible for reviewing investment opportunities and has authority over investment decisions. Limited partners have no discretion over investment decisions and do not take part in day-to-day management activities.

CAPITAL CALLS

In a private equity partnership, capital is drawn down from the limited partners in a series of events known as "capital calls." Private equity managers generally only call capital when they are ready to make an investment. Calling capital without making an investment acts as a "cash drag" on performance. Since fund managers are compensated on performance, they are motivated to closely match capital calls with their investment pace.

The period of time in which the partnership is allowed to make new investments is called the "investment period." Most funds have five- to six-year investment periods that begin once operations commence. Thereafter, the manager usually reserves the right to draw down uncalled capital only to make follow-on investments and cover expenses.

Limited partners are contractually obligated to honor their capital calls as dictated by the terms of the limited partnership agreement. Investors who default on their capital commitments can lose their entire interest in the partnership and are subject to potential legal action by the general partner to collect the unfunded portion of their commitments.

MANAGEMENT FEES AND PROFIT INCENTIVE

In most private equity partnerships, a general partner receives a management fee and a percentage of the profits or "carried interest." Typical management fees run between 1.5% and 2.5% of total capital commitments per year during the commitment period. Thereafter, the base amount on which a management fee is calculated is typically reduced by the cost of realized investments (i.e., the management fee is charged on "invested capital"). In addition to a management fee, a general partner will also earn a carried interest, which is a profit incentive for the general partner (typically 20% of gross profits, although some firms take as much as 30%).

The carried interest is intended to provide the manager with the bulk of its compensation and helps align its interests with those of the limited partners. Many funds also have a "preferred return" feature, which is the minimum IRR that the manager must generate for investors before sharing in profits. The preferred return ensures that the private equity manager will share in the profits of the fund only to the extent that the investments perform at a minimum "acceptable" level, commonly 7-8% for LBO funds. If a manager does not exceed the fund's specified preferred return, it is not entitled to take its carried interest.

In addition, most private equity partnerships have what is called a "clawback" provision, which requires the partnership to undergo a final accounting of all of its capital distributions when the fund is concluded. This task is designed to ensure that the general partner receives no more than its contractual share of the profits. A clawback goes into effect when it is found that the general partner has taken too much carry, a situation that typically arises when there are realized gains on early investments and significant losses on later investments.

Finally, private equity firms may charge fees to their portfolio companies. These fees often represent advisory, transaction, break-up, monitoring and/or other related fees. Most private equity managers will offset a portion of the management fees they charge their limited partners with the fees they earn from their portfolio companies.

RECALLING AND RECYCLING OF CAPITAL

It is common for private equity funds to contain provisions in their terms that permit them to recycle capital. Funds generally have the option to recycle capital in two situations. First, funds may have the ability to reinvest (i.e., "recycle") the cost basis of investments realized within a certain time frame (typically 12 months from the date of initial investment). The ability to recall the capital for reinvestment is generally confined to the time period encompassing the investment period of the fund (typically the first 5-6 years of the partnership). Second, funds may have the ability to reinvest distributions up to the amount of management fees paid to the fund by its limited partners. It is important to note that recycling capital in either case has no impact on the amount of an investor's original commitment to a private equity fund. Recycling capital has the practical effect of potentially increasing the amount of invested capital (above the investor's capital commitment) without a commensurate increase in fees, because fees are capped as a percentage of capital commitments—with capital commitments always remaining constant regardless of the ability to recycle. Recycling provisions may be beneficial to investors, as they enable investors to have additional capital at work, beyond their capital commitment, without an increase in fees (see **Figure 17**).

PRIVATE EQUITY CASH FLOWS

In the early years of the life of a fund, the cash flows are predominantly negative for investors as cash is called by a partnership. In the latter years of a fund, cash begins to flow back to investors in the form of distributions from realized investments, assuming that portfolio companies are sold and profits are realized. The typical holding period for a portfolio company investment in a private equity fund is three to five years before it is realized. Prevailing economic and capital

FIGURE 17: POTENTIAL BENEFITS OF RECYCLING CAPITAL ON EFFECTIVE FEES PAID

Assumptions	• $100 Capital commitment • 1.5% Management fee on capital commitment during the investment period • Cost basis of investments realized with 12 months of investment date can be reinvested within the fund's investment period • Example below assumes the fund is still operating within its investment period
Hypothetical example	• $100 Capital commitment • $100 Capital called from investors ($100 is the maximum investor capital outlay) • $10 Recycled capital (re-invested cost basis of deals realized within 12 months of initial investment date) • $110 Total capital invested • 1.36% Effective management fee on total capital invested assuming recycling of capital • 1.50% Effective management fee without the ability to recycle capital

Source: StepStone analysis.

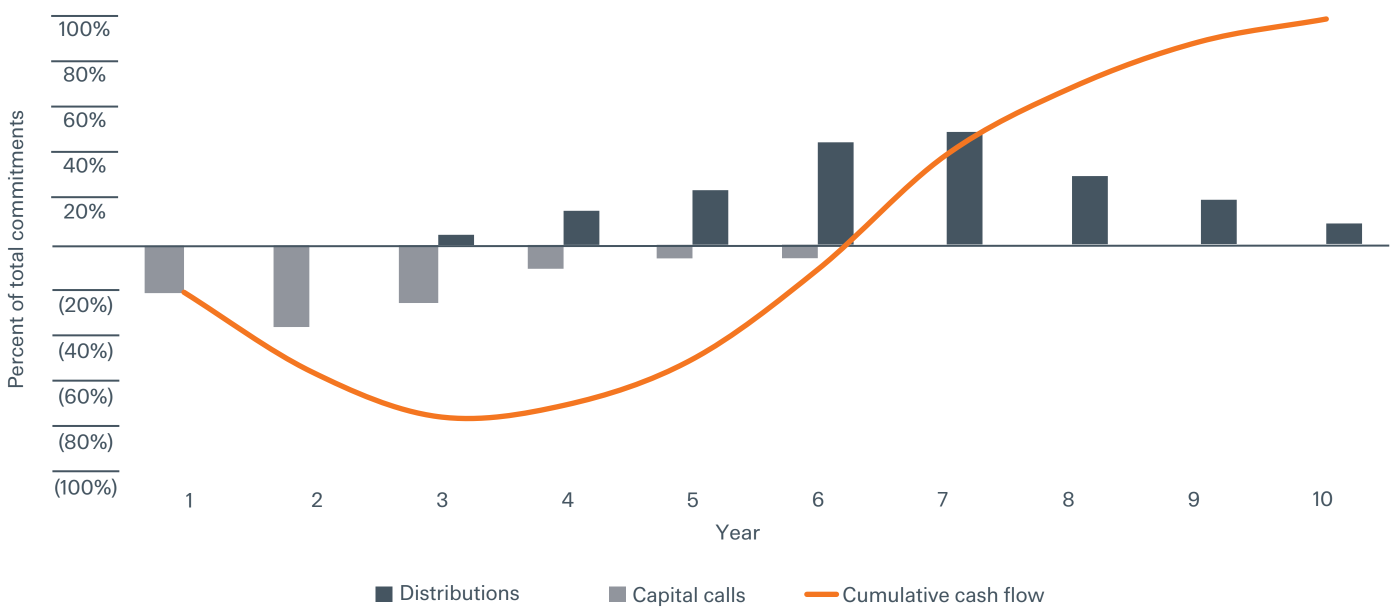
market conditions will also influence the holding period. **Figure 18** illustrates hypothetical cash flows for a typical private equity partnership.

Summary

Private equity investing can play an important role in a well-diversified portfolio. It seeks to achieve excess risk-adjusted returns through value-added investing that exploits market dislocations and unique business opportunities. Private equity investments have the potential to outperform public equity markets; increasingly investors rely on private equity's ability to preserve value during inclement markets conditions.

However, because of the nature of private equity investments extreme care and diligence should be taken when making such investments. Information is less widely disseminated, risks can be difficult to evaluate and investments may be illiquid for many years. These characteristics highlight the importance of accessing this asset class through experienced and diligent private equity teams. Investing in this asset class is intended for investors who are willing to bear the high economic risks of the investment in pursuit of superior returns. Of course, past performance is no guarantee of future results and real results may vary.

FIGURE 18 | HYPOTHETICAL CASH FLOWS OF A PRIVATE EQUITY PARTNERSHIP



Source: StepStone Analysis.
Note: This chart is provided for illustrative purposes only and is not reflective of any actual fund or investment. The chart assumes a 1.9x return multiple over ten years, which represents an IRR of 15.2%.

Private equity glossary

A

Accredited investor – An individual Accredited Investor must have a minimum net worth of $1 million or a gross income in excess of $200,000 (or joint income with the investor's spouse in excess of $300,000) in each of the two previous years and must reasonably expect to maintain that level of income for the current year. An entity Accredited Investor generally must have total assets of $5 million or more.

Angel investor – A wealthy individual, commonly an entrepreneur, who provides backing to businesses or business concepts in their very early stages.

B

Board seats – Private equity firms often acquire board of director positions of the companies in their portfolios, thus giving these firms a means of monitoring and managing the companies in which they have invested.

Bridge financing – Temporary funding that "bridges" the time between receipt of the bridge financing and when it is eventually replaced with permanent capital.

Buyout – see "Leveraged Buyout"

C

Capital account statement – A statement of each limited partner's pro rata share of the partnership's profit, loss, income and assets.

Capital call – When a private equity fund manager (usually a general partner in a partnership) requests that an investor in the fund (a limited partner) provide additional capital. Usually, a limited partner will agree to a maximum investment amount, and the general partner will make a series of capital calls over time to the limited partner as investment opportunities arise. Most general partners call down capital only as they require it, rather than draw it down in preset amounts according to a rigid timetable. Capital may also be called to cover fund expenses.

Carried interest – Carried interest, also referred to as "carry" or "promote," is the share of the partnership profits received by the general partner, with 20% carried interest as the industry standard (although it can be higher or lower in certain cases and varies whether a fund of funds or single-manager fund). The remaining 80% is retained by the limited partners.

Cash multiple – Also known as Return Multiple (see "Distributions to Paid-In Capital")

Catch-up period – Once the general partner provides the limited partners in a fund with their preferred return, if any, the catch-up period begins, during which the general partner receives the majority or all of the profits until the agreed-upon profit split (as determined by the carried interest) is reached.

Clawback – The clawback provision is a common term found in a private equity partnership agreement that requires the partnership to undergo a final accounting of all of its capital distributions when the fund is concluded. This task is designed to ensure that the general partner receives no more than its contractual share of the profits. A clawback goes into effect when it is found that the general partner group has taken too much carry, a situation that typically arises when there are realized gains on early investments and significant losses on later investments.

Co-investor – Although this term is loosely interpreted to mean any two parties investing alongside each other in the same company, in the context of limited partners in a fund, it carries a highly specific meaning. A limited partner in a fund who has co-investment rights can invest directly in a company that is also backed by the fund managers. In this way, the limited partner ends up with two separate stakes in the company: the first indirectly through the private equity fund to which the limited partner has contributed; the second through its direct investment. Some private equity firms offer co-investment rights to encourage limited partners to invest in their funds.

Commitment – A limited partner's obligation to provide a certain amount of capital to a fund. The period in which an investor's obligation to contribute capital to the private equity fund for investment purposes—typically, the first four to five years of the term of the fund—is called the "commitment period."

Compound Annual Growth Rate ("CAGR") – The year over year growth rate applied to an investment or other aspect of a firm using a base amount.

D

Deal flow – The rate at which a fund reviews the number of potential investments in any given period.

Distressed debt – A private equity or hedge fund investment strategy that involves the purchase of debt securities trading at a significant discount to par value.

Distributions – Cash or stock returned to the limited partners after the general partner has exited from an investment. A stock distribution is sometimes called an "in-kind" distribution.

Distributions to paid-in capital (also known as "Cash Multiple" or "Return Multiple") – The amount a partnership has distributed to its investors relative to the total capital contribution to the fund. Return multiples, coupled with IRRs (see definition), are typical performance metrics used in evaluating private equity investment performance.

E

Early stage – A fund investment strategy involving investment in startups for initial product development, marketing, manufacturing and sales activities.

Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") – A measure of a company's cash flow, calculated by looking at earnings before the deduction of interest expenses, taxes, depreciation and amortization. EBITDA is often used as a measure of financial performance for leveraged companies, such as those that have undergone a leveraged buyout.

Exit – The means by which a private equity firm realizes a return on its investment. This typically comes when a portfolio company goes public, or when it merges with, or is acquired by, another company.

F

Financial buyer – This term typically describes private equity managers or financial institutions that purchase companies or assets for purposes of reselling them for a profit at a later date.

G

General partner – Term used to distinguish the firm that is managing the private equity fund on behalf of the limited partners (i.e., the individuals or the institutional investors who provide capital to the fund).

General partner contribution – The amount of capital that the fund manager contributes to its own fund in the same way that a limited partner does. This can be an important way in which limited partners can ensure that their interests are aligned with those of the general partner.

Growth stage (also known as "middle stage") – A fund investment strategy involving financing for a company that has received one or more rounds of financing and is generating revenue from its product or service.

I

Internal rate of return ("IRR") – The IRR is a measure of private equity performance. IRRs are determined by the amount and timing of cash inflows and outflows, as well as the residual value of investments at the end of the measurement period. Gross IRR refers to the rate of return before management fees, expenses, and carried interest. Net IRR refers to the rate of return after management fees, expenses and carried interest. There are several different methodologies for computing IRRs. Two popular methods are the "calendar time" and the "time zero" methods. The "calendar time" approach (sometimes called "dollar-weighted" in the private equity industry press) entails lining up all drawdowns and returns of capital in the year(or quarter, month or even the day) during which they occurred. The "time zero" method assumes that all investments are made at the inception of the fund. These different methods can produce dramatically different IRRs.

J

J-curve – The J-curve is a term used to describe the impact of management-fee drag and potential writedowns of underperforming portfolio companies on the performance of a private equity fund early on in the fund's lifecycle. These combined effects generally cause performance (as measured by IRRs) to dip down, taking the shape of the letter "J," in the early years of the life of the fund when most of the portfolio is typically held at cost.

L

Later stage – A fund investment strategy involving financing for the expansion of a company that is producing, shipping and increasing its sales volume.

LBO (Leveraged buyout) – A fund investment strategy typically involving the acquisition of a relatively mature product or business, from either a public or private company, utilizing a significant amount of debt (typical LBO transactions today are funded with about 30%-40% equity and 60%-70% debt).

Lead investor – The firm or individual that organizes a round of financing and usually contributes the largest amount of capital to the deal.

Leverage – The use of borrowed money to acquire assets, build operations and increase revenues. By using debt, a company attempts to achieve these results faster. But if the company underperforms, it may be at risk of not being able to make payments on the debt.

Limited partner(s) – Institutions or individuals contributing capital to a private equity fund. Limited partners typically are pension funds, private foundations, university endowments and high net worth individuals.

Limited partnership – The legal structure used by most private equity funds, usually fixed-life investment vehicles. The general partner or management firm manages the partnership using the policy laid down in a partnership agreement, which also covers terms, fees, structures and other items agreed upon between the limited partners and the general partner.

M

Management buy-out (MBO) – The acquisition of a company by its management, often with the assistance of a private equity investor.

Management fee – An annual fee, typically a percentage of limited partner commitments to a fund, appropriated to cover the basic costs of running and administering a fund. Management fees tend to run in the range of 1.5% to 2.5% per year. In the later years of a partnership, these fees are often scaled down to reflect the reduced workload of the general partner. Unlike carried interest, management fees are not intended to be primary sources of incentive compensation for investment teams.

Mezzanine financing – Mezzanine financing can have different meanings as it relates to both VC and buyouts. With respect to VC, mezzanine financing can be defined as an investment provided to a company that is already producing and selling a product or service, for the purpose of helping the company achieve a critical objective that will enable it to go public. Within the context of buyouts, mezzanine financing is an investment strategy involving subordinated debt (the level of financing senior to equity and below senior debt).

N

NASDAQ Composite – The NASDAQ Composite is an unmanaged stock index with an emphasis on technology-oriented companies. Investing in the NASDAQ Composite is subject to sector risk as well as the general risks of equity investing, which include, among others, market risk and the volatility of returns.

O

Overhang – Private equity capital that has already been raised but has yet to be invested.

P

PIPEs – An acronym for “private investing in public entities.” The term specifically denotes a private investment in a publicly held company.

Portfolio company – The term used to describe an investment in a company held by a private equity manager.

Preferred return – The preferred return is the minimum annual IRR sometimes provided to the limited partners before the general partner shares in profits. In effect, the preferred return ensures that the general partner will share in the profits of the partnership only to the extent that the investments perform at a minimum “acceptable” level.

Pre-money valuation – Typically, a VC valuation metric that refers to the value of a company before an investor’s money is invested. It is usually contrasted with post-money valuation that combines a company’s pre-money valuation with the value of the money invested. For example, a company with a pre-money valuation of $10 million that receives $5 million in investment would have a post-money valuation of$15 million, consisting of the $10 million pre-money value of the company plus the $5 million invested.

Private equity – Negotiated and often highly structured private investments in companies in return for an ownership interest. Private equity investments are generally illiquid and, as such, are considered long-term investments. Private equity is composed of, but not limited to, the following subcategories: leveraged buyouts, VC, mezzanine debt financing, distressed debt, real estate, development capital and special situations.

Private placement – This term is used specifically to denote a private investment in a company that is publicly or privately held.

Purchase multiple – Typically, a buyout valuation metric that refers to the multiple of cash flow (i.e., EBITDA—earnings before interest, taxes, depreciation and amortization) that a private equity firm pays in the acquisition of a company.

Q

Qualified purchaser – These include individuals and family entities with minimum net investment assets of $5 million or other entities with minimum net investment assets of $25 million (e.g., corporations, public foundations and endowments).

R

Ratchet – A provision that enables a VC firm to maintain its percentage ownership in a company despite the company's future issuance of additional shares to other entities.

S

Schedule K-1 statement – The Internal Revenue Service form sent to investors by a partnership, which provides the flow-through income and expenses to be reported on an investor's individual tax return.

Seed-stage investment – Seed rounds are initial rounds invested in companies at very early stages of development, typically with the founders and product developers on board but without a complete management team in place.

Standard & Poor's 500 Index – The Standard & Poor's 500 Index ("S&P 500") is a capitalization-weighted index of 500 stocks trading in US equity markets. Performance is calculated on a total return basis.

Strategic buyer – This term typically describes larger corporations that purchase smaller companies or assets that relate to their core group of businesses. Strategic buyers can often extract synergies from the purchase of complementary assets. Private equity managers can sell their portfolio companies to strategic buyers as a means of realizing their investment.

V

Venture capital – Venture capital typically refers to money provided by investors to development-stage, privately held companies that are early in their life cycle with perceived high growth potential.

Vintage – A term used to describe the year of fund formation and first takedown of capital. The concept of vintage year is used when benchmarking the performance of different private equity funds.

W

Write-down – A reduction in the value of an investment.

Write-off – The write-down of a portfolio company's holdings to a valuation of zero, in which case the private equity investors receive no proceeds from their investment and the investment is usually removed from the fund's portfolio.

We are global private markets specialists delivering tailored investment solutions, advisory services, and impactful, data-driven insights to the world's investors. Leveraging the power of our platform and our peerless intelligence across sectors, strategies, and geographies, we help identify the advantages and the answers our clients need to succeed.

For more information regarding StepStone's research, please contact us at research@stepstonegroup.com.

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