

# PRIVATE EQUITY EXPLAINED

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# What Is Private Equity?

Private Equity is capital – specifically, shares representing ownership of or an interest in an entity – that is not publicly listed or traded. It is composed of funds and investors that invest in private companies, or that buyout public companies with the intention to take them private.

A private equity fund has *Limited Partners* (LP), who typically own 99% of shares in a fund and have *limited liability*, and General Partners (GP), who own 1% of shares and have full liability. The latter is also responsible for executing and operating the investment.

## Private Equity Regulation

Since the modern private equity industry emerged in the 1940s, it mainly operated unregulated until the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into federal law in 2010. Dodd-Frank was drafted to address the problems that contributed to the financial crisis of 2008.

Before Dodd-Frank, general partners in private equity funds had exempted themselves from the Investment Advisers Act of 1940, which sought to protect investors by monitoring the professionals who offer advice on investment matters. Private equity funds were able to be excluded from the legislation by restricting their number of investors and meeting other requirements. However, Title IV of Dodd-Frank erased the "private adviser exemption" that had allowed any investment advisor with less than 15 clients to avoid registration with the Securities And Exchange Commission (SEC).

Dodd-Frank requires all private equity firms with more than \$150 million in assets to register with the SEC as "Investment Advisers." The registration process began in 2012, the same year the SEC created a special unit to oversee the industry. Under the new legislation, private equity funds are also required to report information covering their size, services offered, investors, employees, and potential conflicts of interest.

# What is Private Equity in Relation to Real Estate

Private equity is an *alternative investment* class and consists of capital not listed on a public exchange. Private equity investment comes primarily from *institutional investors* and *accredited investors*, who can dedicate substantial sums of money for extended periods, making it ideally suited to property development projects.

Private equity offers several advantages to companies, property developers and startups. Companies and developers favour it because it allows them access to liquidity as an alternative to conventional financial mechanisms, such as high-interest bank loans or listing on public markets.

For construction and development projects the developer may offer potential profits gains at the end of the project and sale of the asset.

Private equity comes with its unique riders. First, it can be difficult to liquidate holdings in private equity because, unlike public markets, a readymade order book that matches buyers with sellers is not available. A firm has to search for a buyer to make a sale of its investment or company.

Second, the pricing of shares for a company in private equity is determined through negotiations between buyers and sellers and not by market forces, as is generally the case for publicly-listed companies.

Third, the rights of private equity shareholders are typically decided on a case-by-case basis through negotiations instead of a broad governance framework that typically dictates rights for their counterparts in public.

# How Does Private Equity Work

Private equity firms raise money from institutional investors and accredited investors to invest in different types of assets. Some of the more popular types of private equity are:

- **Distressed funding:** Also known as vulture financing, money in this type of funding is invested in troubled companies with underperforming business units or assets. The intention is to turn them around by making necessary changes to their management or operations or making a sale of their assets for a profit.
- **Leveraged Buyouts:** This is the most popular form of private equity funding and involves buying out a company entirely to improve its business and financial health and reselling it for a profit to an interested party or conducting an IPO.
- **Real Estate Private Equity:** Typical areas where funds are deployed are commercial real estate and real estate investment trusts (REIT). Real estate funds require higher minimum capital for investment than other funding categories in private equity. Investor funds are also locked away for several years at a time in this type of funding. According to research firm Prequin, real estate funds in private equity are expected to clock in a 50 per cent growth by 2023 to reach a market size of US\$1.2 trillion.
- **Fund of funds:** As the name denotes, this type of funding primarily focuses on investing in other funds, mainly mutual funds and hedge funds. They offer a backdoor entry to investors who cannot afford minimum capital requirements in such funds. But critics of such funds point to their higher management fees (because they are rolled up from multiple funds) and that unfettered diversification may not always result in an optimal strategy to multiply returns.
- **Venture Capital:** Venture capital funding is a form of private equity, in which investors, also known as angels, provide capital to entrepreneurs.



## How Do Private Equity Firms Make Money?

The primary source of revenue for private equity firms is in fee revenue.

## Private Equity Fees

Private equity funds have a similar fee structure to hedge funds, typically consisting of a *management fee* and a *performance fee*. Private equity firms typically charge annual management fees of around two per cent of the *fund's committed capital*.

The performance fee is usually in the region of 20% of profits from investments, and this fee is known as *carried interest*.

The method by which capital is allocated between investors and the *general partner* in a private equity fund is described in the *distribution waterfall*.

The waterfall specifies the carried interest percentage that the general partner will earn and also a minimum percentage rate of return, called the *preferred return*, which must be obtained before the general partner in the fund can receive any carried interest profits.



## What is an Alternative Investment?

An alternative investment is an asset that is not one of the conventional investment types, such as stocks, bonds and cash.

Alternative investments include private equity, hedge funds, managed futures, real estate, commodities and derivatives contracts. Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of the complex natures and limited regulations of the investments.

Many alternative investments have higher minimum investments and fee structures than mutual funds and exchange-traded funds (ETFs). There is also less opportunity to publish verifiable performance data and advertise to potential investors. Most alternative assets have low liquidity compared to conventional assets.

## Alternative Investments for Diversification and Hedging

Alternative investments typically have a low correlation with standard asset classes, making them suitable for portfolio diversification. Because of this, many large institutional funds such as pensions and private endowments allocate a small portion of their portfolios to alternative investments such as hedge funds.

## Regulation of Alternative Investments

Alternative investments are often subject to a less clear legal structure than common investments. Still, they are increasingly regulated in the US by the Dodd-Frank Wall Street Reform and Protection Act. However, they are still not overseen as closely as mutual funds and ETFs by the Securities and Exchange Commission (SEC) and the Financial Industry Regulation Commission. Often, only those deemed "accredited investors" have access to alternative investment offerings.

## What is an Institutional Investor

An institutional investor is an organization that invests on behalf of its members. Institutional investors face fewer protective regulations because it is assumed they are more knowledgeable and better able to protect themselves. There are generally six types of institutional investors: endowment funds, commercial banks, mutual funds, hedge funds, pension funds and insurance companies.

## What is an Accredited Investor

An accredited investor is a person or a business entity who is allowed to deal in securities that may not be registered with financial authorities. They are entitled to such privileged access if they satisfy one (or more) requirements regarding income, net worth, asset size, governance status or professional experience.



## What is a High Net Worth Individual?

Financial services regulators and financial institutions generally define a high net worth individual (HNWI) as having liquid assets over a specific figure. For example, in the US, an accredited/qualified investor is one with an annual income of at least \$200,000 in each of the past two years (\$300,000 for joint income) or a net worth of at least \$1 million, excluding a personal residence.

An accredited investor, in the context of individuals, includes anyone who: earned income that exceeded \$200,000 (or \$300,000 together with a spouse) in each of the prior two years and reasonably expects the same for the current year, OR has a net worth over \$1 million, either alone or together with a spouse (excluding the value of the person's primary residence). The person must satisfy the thresholds for the three years consistently either alone or with a spouse on the income test.

In addition, entities such as banks, partnerships, corporations, nonprofits and trusts may be accredited investors. Any trust, with total assets above \$5 million, not formed to specifically purchase the subject securities, whose purchase is directed by a sophisticated person, or any entity in which all of the equity owners are accredited investors.

In this context, a sophisticated person means the person must have, or the company or private fund offering the securities reasonably believes that this person has sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the prospective investment (Source: The Office of Investor Education and Advocacy, Securities And Exchange Commission)

In the United Kingdom, a High Net Worth Individual (HNWI) is an individual who has self-certified that they had, during the previous financial year an annual income to the value of £100,000 or more; or they held, throughout the financial year immediately preceding the date in question, net assets to the value of £250,000 or more. Net assets for these purposes do not include:

- the property which is the individual's primary residence, or any loan secured on that residence;
- any rights of the individual under a qualifying contract of insurance within the meaning of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001;
- any benefits (in the form of pensions or otherwise) which are payable on the termination of the individual's service or on their death or retirement and to which they are (or their (or their dependents are), or may be, entitled. (Source: The

In Singapore, a "high net worth individual" is an individual – (a) who has a minimum of S\$1 million of assets, or the equivalent in foreign currencies, in any or all of the following forms: (i) bank deposits, including structured deposits; (ii) capital markets products; (iii) life policies; (iv) other investment products as may be prescribed by the Authority; (b) whose total net personal assets exceed S\$2 million in value or the equivalent in foreign currencies; (c) whose annual income is not less than S\$300,000 or the equivalent in foreign currencies; or (d) who is assessed by the applicant to have the potential to become a person described in (a) within two years. (Source: Monetary Authority of Singapore)

In Hong Kong, the SFO provides for two types of professional investors, namely:

1. entities specified in paragraphs (a) to (i) of the definition of "professional investor" in Part 1 of Schedule 1 to the SFO (e.g. banks and insurance companies). These are Institutional Professional Investors; and
2. high net worth professional investors as set out in the Securities and Futures (Professional Investor) Rules (Cap 571D)

There are four types of high net worth professional investors, namely:

- (a) a trust corporation entrusted with total assets of not less than HK\$40 million (or its foreign currency equivalent);
- (b) a corporation or partnership with either a portfolio of not less than HK\$8 million (or its foreign currency equivalent) or total assets of not less than HK\$40 million (or its foreign currency equivalent);
- (c) an individual who, either alone or with his/her associate(s) (i.e. spouse and children) in a joint account, has a portfolio of not less than HK\$8 million (or its foreign currency equivalent); and
- (d) a corporation the sole business of which is to hold investments, and which is wholly owned by any of the persons falling within paragraphs (a), (b) or (c) above. (Source: The Securities and Futures Commission)

# What is a Distribution Waterfall

The distribution waterfall is the order in which a private equity fund makes distributions to limited and general partners.

A distribution waterfall describes how capital is distributed to a fund's investors as underlying investments are sold. Investment waterfalls are detailed in the distribution section of the private placement memorandum (PPM). There are two common types of waterfall structures, American and European, and they can exist in either an individual deal or fund structure.

A European-style distribution schedule is applied at an aggregate fund level. With this schedule, all distributions will go to investors, and the manager will not participate in any profits until the investor's capital and preferred return have been fully satisfied. A drawback is that most of the manager's profits may not be realised for several years after the initial investment.

An American-style distribution schedule is applied on a deal-by-deal basis and not at the fund level. The American schedule spreads the total risk over all the deals and is more beneficial to the fund's general partners. This structure allows managers to get paid before investors receive their preferred return and 100 per cent of invested capital. In this structure, a manager could receive a disproportionate share of cash flow right away.

## Distribution waterfall schedules

Though tiers may be customized, generally, the four tiers in a distribution waterfall schedule are: return of capital; preferred return; catch-up and carried interest. With the return of capital, 100 per cent of distributions go to the investors until they recover all of their initial capital contributions. In preferred return, 100 per cent of further distributions go to investors until they receive the preferred return on their investment. Usually, this tier's preferred rate of return is approximately 7 per cent to 9 per cent.

The catch-up tranche is structured, so 100 per cent of the distributions go to the fund's sponsor until it receives a certain percentage of profits. The fourth tier is structured so the sponsor gets a stated percentage of distributions as carried interest. The stated percentage in the fourth tier must match the stated percentage in the third tier. Hurdle rates for the schedule also may be tiered, depending on the general partners' total amount of carried interest.



Typically, the more carried interest, the higher the hurdle rate. The claw back feature is detailed in the PPM and entitles investors to be repaid any incentive fees taken by the manager during the life of the investment.

## What is a Hurdle Rate

A hurdle rate is the minimum rate of return required on a project or investment. Hurdle rates give companies insight into whether they should pursue a specific project. Riskier projects generally have a higher hurdle rate, while those with lower rates come with lower risk.

A hurdle rate is also referred to as a break-even yield.

## What is Carried Interest

Carried interest, or carry, is a share of any profits that the general partners receive as compensation, regardless of whether they contributed any initial funds.

Carried interest serves as the primary source of income for the general partner, traditionally amounting to around 20 to 25% of the fund's annual profit. While all funds tend to charge a small management fee, it is meant only to cover the costs of managing the fund, with the exception of compensating the fund manager. However, the general partner must ensure that all the initial capital that the limited partners contribute is returned along with some previously agreed-upon rate of return.

Carried interest is often only paid if the fund achieves the minimum return known as the hurdle rate.

This method of compensation seeks to motivate the general partner (fund manager) to work toward improving the fund's performance.

## How Carried Interest Works

The general partner is compensated through an annual management fee, which typically amounts to 2% of the fund's assets. The carried interest portion of a general partner's compensation is vested over several years and received as earned after that point. The private equity industry has always maintained that this is a fair compensation arrangement because general partners invest a tremendous amount of time and resources toward building the companies in their portfolios to profitability. Much of the general partner's time is spent developing strategy, improving management performance and company efficiencies, and maximizing the value of a company in preparation for its sale or initial public offering (IPO).

Carried interest is not automatic; it is only created when the fund generates profits that exceed a specified return level known as the hurdle rate. If the hurdle rate of return is not achieved, the general partner does not receive carry, although the limited partners receive their proportionate share. Carry can also be "clawed back" if the fund underperforms. For example, if the limited partners are expecting a 10% annual return, and the fund only returns 7% over a period of time, a portion of the carry paid to the general partner could be returned to cover the deficiency.

When added to the other risks the general partner undertakes, the claw back provision leads private equity industry advocates to their justification that carried interest is not a salary; instead, it is an at-risk return on investment that is only payable based on performance achievement.

## What is a Private Investment Fund?

A private investment fund is an investment company that does not solicit capital from retail investors or the general public. To be classified as a private investment fund, in the US a fund must meet one of the exemptions outlined in the Investment Company Act of 1940..

There is an advantage to maintaining private investment fund status, as the regulatory and legal requirements are much lower than required for funds traded publicly.

Private investment funds are expected to meet specific criteria to keep their status. Generally, the requirements limit both the number and type of investors who can own the fund's shares. In the US a 3C1 fund can have up to 100 accredited investors and a 3C7 fund can have a soft limit of around 2,000 qualified investors.

## What is Committed Capital

Committed capital (also known as "commitments") is a contractual agreement between an investor and a fund that obligates the investor to contribute money to the fund. The investor may pay all of the committed capital at one time or make contributions over a period of time.

When an investor commits capital to a venture capital fund, the investor typically has many years to satisfy the agreement. Often, contributions will be made over three to five years after the fund is formed. Committed capital may be used by fund managers as a vehicle to cover investments or fees by calling for contributions as needed to be deposited in the fund within a specific agreed-upon timeframe.



Committed capital may be put toward a so-called blind pool where the investor does not know precisely how or where the money is to be invested. Such an arrangement offers fund managers leeway to make investments as they deem appropriate to better generate high internal rates of return for the investors..

As committed funds are called upon to make investments, the contributing investors will be granted a portion of the investment's overall returns to the fund. While committed capital does not indicate immediate liquidity, it can demonstrate a fund's capacity to pursue and fulfil deals.

The terms of the agreement for committed capital usually include penalties and fees if the money is not contributed by the designated time by the investor. This can include interest charges on the capital that has not been contributed on time and further action that limits or even eliminates the derelict investor's further participation in the fund. In such cases, the investor may be limited in terms of profits they may recoup from the fund. The investors may also be forced to sell their interest in the fund to partners in good standing or possibly to third parties.

## What is a Limited Partner

Also known as a silent partner, a limited partner is a business partner whose liability is limited to the amount of their investment in the company. A limited partner who participates in a partnership for more than 500 hours in a year may be viewed as a general partner.

A limited partnership (LP) has at least one general partner and at least one limited partner.

## What is a General Partner

A general partner is an owner of a partnership who has unlimited liability. General partners typically create a partnership agreement to spell out the details of their partnership. Unlike other business entities such a corporation or a limited liability corporation (LLC), in the US no state filing is required to form a partnership.

A general partner is an owner of a partnership who has unlimited liability. A general partner is also usually a managing partner and is active in the business's day-to-day operations. Because any partner in a general partnership can act on behalf of the entire business without the knowledge or permission of the other partners, being a general partner offers poor asset protection.

If a general partner is ever required to meet the partnership's financial obligations, his or her personal assets may be subject to liquidation. In the case of a limited partnership, only one of the partners will be the general partner and have unlimited liability. The other partners will have limited liability as long as they do not take an active role in managing the business, so their personal assets will not be at risk.

The disadvantages of being a general partner pertain to the issue of liability. General partners are jointly and severally liable for the partnership's legal obligations, including contracts and personal injury suits.

## What is a Limited Liability

In a partnership, the limited partners have limited liability, while the general partner has unlimited liability. The limited liability feature protects the partner's personal assets from the risk of being seized to satisfy creditor claims in the event of the company's or partnership's insolvency. By contrast, the general partner's personal property would remain at risk.

When either an individual or a company function with limited liability, assets attributed to the associated individuals cannot be seized to repay debt obligations attributed to the company. Funds that were directly invested with the company, such as the purchase of company stock, are considered assets of the company in question and can be seized in the event of insolvency.

Any other assets deemed to be in the company's possession, such as real estate, equipment and machinery, investments made in the institution's name, and any goods that have been produced, but have not been sold, are also subject to seizure and liquidation.

In the context of a private company, being incorporated can provide its owners with limited liability since an incorporated company is treated as a separate and independent legal entity.

## **Liability for General and Limited Partners**

A general partner typically receives payment for controlling the company's daily operations and making legally binding decisions. A general partner is personally liable for business debts and legal proceedings. For example, if one general partner cannot pay a creditor's debt, the creditor may collect from another general partner.

A limited partner invests capital in exchange for shares in the partnership. A limited partner has restricted interaction in the business's practices. They cannot incur obligations on behalf of the partnership, participate in daily operations, or manage the operations.

Because the limited partner does not control managing operations, they are not personally liable for the partnership's debts. However, a limited partner may become personally liable if they assume an active role in the business. To claim against the limited partner, the creditor must prove that they engaged in activities aligned with general partner duties. If confirmed, the limited partner may be fully liable for the creditor's claims.

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Sources include:

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