Private Equity Explained

Center Forward Basics
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Overview

Private equity (PE) firms invest money and entrepreneurial expertise into companies poised for growth or underperforming or undervalued businesses that have potential for long-term growth. The PE industry has a large impact on the U.S. economy, including dramatic turnaround and expansion stories like Popeyes, Hilton Hotels, Dunkin' Donuts, and Beats Headphones. According to recent studies, in 2018, the U.S. PE industry directly employed 8.8 million workers with $685 billion invested in thousands of companies.

The Private Equity Process

In a typical PE fund structure, a **General Partner investor (GP)** at a PE firm establishes and runs the funds. GPs typically employ extensive industry and operational expertise and invest money into each fund. **Limited Partner investors (LP)** are sophisticated investors, including public and private pension funds, university endowments, charitable foundations, sovereign wealth funds, or high-net worth individuals. LP investors contribute most of the money for a fund's investments.

PE funds typically buy promising companies that are poised to grow and expand, or up-and-coming companies that need working capital and managerial expertise to compete in the global marketplace, or more mature businesses that need assistance. Then, PE works to improve the operations, governance, and the competitiveness of the business by investing capital, time, and expertise into strengthening the business. These improvement strategies often include injecting managerial talent, advancing production technology, and expanding distribution channels. Through PE firms' expertise, the goal is for underperforming businesses to improve their operations and become successful companies on track for positive, long-term growth.

After three to seven years of improving the company, a PE fund then sells it for a higher value than it was purchased. This can occur through an initial public offering, or a strategic sale to another investor. LP investors receive back the proportional capital they contributed to the investment, plus expenses and a hurdle rate of return on their invested capital, typically 8%, before the remaining profits are split 80/20 with the LPs receiving 80% and the GPs receiving 20%, which is known as carried interest.

Carried Interest

Carried interest is the portion of investment profits that fund GP investors retain and realize after LP investors have achieved repayment of their original investment in the fund plus expenses plus a hurdle rate of return. Since its

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Center Forward brings together members of Congress, not-for profits, academic experts, trade associations, corporations and unions to find common ground. Our mission: to give centrist allies the information they need to craft common sense solutions, and provide those allies the support they need to turn those ideas into results.

In order to meet our challenges we need to put aside the partisan bickering that has gridlocked Washington and come together to find common sense solutions.

For more information, please visit www.center-forward.org

Key Facts

- Terms to know:
  - Internal Rate of Return (IRR): the internal net return earned by investors (limited partners), from the fund from inception to a stated date.
  - Hurdle Rate: the rate of return that private equity fund managers must return to their investors before they can realize carried interest.
- The PE industry's primary regulator in the United States is the Securities and Exchange Commission (SEC). The Dodd-Frank Wall Street Reform and Consumer Protection Act

inception, the U.S. tax code has treated carried interest on the sale of capital assets as capital gains income. This tax law provides incentives for PE firms and other entrepreneurs (i.e. venture capital firms, real estate development firms, etc.) to take risks and invest in businesses over the long-term. In summary, carried interest capital gains aligns GP investors' interests with those of the fund's LP investors. If the fund's long-term investments are successful (i.e. sell company for gain), the GP shares in the gains. If the fund's investments are not successful (i.e. Chapter 7 bankruptcy liquidation), the GP receives no carried interest. As an additional incentive for the alignment of partners' interest, carried interest realized on a successful fund investment can also be clawed back from recipients if the fund's subsequent investments fail to satisfy the hurdle rate of return. The Joint Committee on Taxation has estimated that increasing taxes on carried interest capital gains to equal ordinary income tax rates for all industries (i.e. PE, venture capital, real estate, and others) would generate approximately $14 billion over 10 years.

U.S. Private Equity is the Best Performing Asset Class for Public Pensions

Recent research from professors Gregory Brown of the University of North Carolina and Steven Kaplan of the University of Chicago found that PE continues to significantly outperform the public markets. In fact, their research found that PE investments continue to generate returns 2% to 3% above public equity markets. Additionally, the American Investment Council's annual public pension study found that among public pension funds, the best returning asset class is PE with a median return of 10.2% over 10 years, after the fees and carried interest.

U.S. Private Equity Investment

In 2018, the U.S. PE sector—U.S. PE firms, funds, and U.S. PE-backed companies—accounted for approximately $1.1 trillion of value added to the U.S. economy. This figure represented approximately 5% of the U.S. Gross Domestic Product. Business products and services and consumer products and services attracted nearly half of the United States PE investment.

Private Equity is Regulated

PE is regulated primarily by the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940 and other securities laws. The Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the already robust regulatory structure for PE, by requiring PE investment advisers with more than $150 million of Regulatory Assets Under Management (RAUM) to register with the SEC. Registered PE advisers must file a Form ADV at least annually (or more frequently with material changes to their activity). Form ADV provides the public and regulators with extensive organizational and operational information about the advisers and the funds they manage. In addition, registered PE advisers are also required to file Form PF at least annually on a confidential basis with the SEC. Form PF provides regulators with additional information regarding fund size, portfolio company leverage, liquidity, and types of investors. While most policymakers recognize that neither PE firms nor funds nor portfolio companies are sources of systemic risk, the SEC is able to share Form PF data with other regulators who make up the Financial Stability Oversight Council (FSOC).

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- 47% of capital invested in private equity comes from pensions.
- Top five states receiving the most PE investment:
  - Texas: $111 billion capital invested in 482 companies
  - California: $86 billion capital invested in 665 companies
  - New York: $44 billion capital invested in 313 companies
  - Tennessee: $33 billion capital invested in 101 companies
  - Minnesota: $31 billion capital invested in 89 companies
- Examples of successful PE investments: