Morgan Stanley
INVESTMENT MANAGEMENT

Private Equity Primer: An Introduction to Private Equity Basics

PRIVATE EQUITY | MORGAN STANLEY PRIVATE EQUITY SOLUTIONS TEAM | SEPTEMBER 2024

Most investors are familiar with traditional investments, which include cash and long-only positions in publicly traded stocks and bonds. Alternative investments are comprised of more complex investments and include private strategies focused on illiquid holdings. Within the private alternatives universe, asset classes include private equity, private credit, real estate and infrastructure. Among these asset classes, private equity is one of the most rapidly growing with assets under management quadrupling over the last two decades from $2.2 trillion in 2000 to $8.5 trillion as of June 2023.[1]

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Founded in 1999, Morgan Stanley Private Equity Solutions is a leading limited partner in private markets with a 25-year history serving as a partner of choice to high-quality financial sponsors. The team's broad private markets investment platform encompasses globally diversified fund of funds programs, custom mandates, and specialized programs offering exposure to primary funds, co-investments, secondaries, venture capital, and impact, among other strategies.[2]

DISPLAY 1
Differences Between Traditional Investments and Private Investments

	TRADITIONAL INVESTMENTS	PRIVATE INVESTMENTS
Ownership	Publicly traded	Privately held
Liquidity	High	Limited
Investor Base	Broad	Historically institutional

What Is Private Equity?

Private equity (PE) can be defined as equity or equity-like investments made into private companies or assets (i.e., not publicly traded or listed on a stock exchange). In general, private equity fund managers, also known as general partners (GPs), are analogous to the managers of mutual funds, with a key difference being that these general partners construct portfolios of privately held, rather than publicly traded, companies or assets. Like mutual fund managers, and unlike hedge funds, private equity fund managers acquire long-only interests in underlying companies (portfolio companies). Unlike their

[1] Source: Preqin, February 2024. Alternatives sector includes PE, private credit, real estate, infrastructure and natural resources.

[2] Diversification does not eliminate the risk of loss.

public-oriented counterparts, however, PE GPs typically hold each of their portfolio companies for several years.

Following such multi-year hold periods, a GP will seek to exit its stake in a company or asset at a gain relative to its entry price (or valuation) through a negotiated sale or initial public offering (IPO). A GP seeks to deliver gains across a portfolio of such companies, making PE funds largely illiquid relative to mutual funds.

What Are the Key Private Equity Strategies?

There are three main strategies within private equity—buyout, growth equity, and venture capital. All encompass actively constructing and managing portfolios composed of equity interests in privately held companies that are each individually selected in exchange for either a capital investment into a company (primary) or as a payment to an existing equity holder (secondary). The strategies' target investments vary, however, in terms of ownership levels, portfolio company stage, and/or financing approach.

- **Buyout:** Buyout investments represent the largest strategy segment within private equity as measured by assets under management. A buyout typically involves a controlling ownership stake in a mature company via a secondary investment (i.e., a payment to a shareholder disposing of their equity position either partially or fully) typically financed with a combination of cash and debt.
- **Growth Equity:** Growth equity investments usually focus on companies that are established but that are growing much more rapidly than a typical buyout-oriented transaction. Additionally, growth capital investments tend to be financed with lower levels of debt than seen in the buyout segment. Finally, the growth equity segment tends to be quite flexible with ownership stakes ranging from minority to majority and investments ranging from full primary to full secondary.
- **Venture Capital:** Venture capital investments are generally made in early-stage businesses that have the potential to grow very quickly, but that rely on one or multiple rounds of investment funding in order to achieve such growth. As such, venture capital investments are primary in nature whereby the fund manager making the venture capital investment (a venture capitalist) contributes cash to the balance sheet of a given company in exchange for a minority ownership stake often as part of a syndicate with other investors. The stages of venture capital financing are often reflective of a company's maturity and/or size. For instance, pre-seed and seed investments involve start-up companies that in some cases have no revenue and only a founding management team; later stage investments target companies that may have billions in revenue and thousands of employees but are not yet profitable.

How Can Investors Access Private Equity?

Historically, private equity has been associated primarily with institutional investors and family offices that meet certain requirements for wealth, income, or financial knowledge (i.e., qualified purchasers) and that can tolerate illiquidity and a relatively long investment horizon.[3] However, several recent innovations are making PE investing more widely accessible to individual investors.

DISPLAY 2

Ways Investors Can Access Private Equity

PRIVATE COMPANY	PRIVATE EQUITY FUND	MULTI-MANAGER FUND
■ Direct investment in a pre-identified privately held asset whereby an investor might acquire a direct equity interest in that company ■ Promising upside potential if one selects well ■ High concentration risk ■ Can be difficult to access attractive opportunities	■ An investment vehicle that pools capital from investors, or limited partners (LPs), which the GP then uses to invest in a portfolio of underlying private companies or assets ■ Moderate upside potential if one selects well ■ Diversification via exposure to multiple companies[4] ■ Concentration risk, as the success of the fund depends on a single manager's ability to execute strategic and operational initiatives to drive value and to sell underlying companies in order to realize gains	■ Similar investment vehicle structure to a private equity fund. However, instead of pooling commitments to invest in underlying companies, the fund invests in other private equity funds ■ Unique way for investors to gain access to strategies or managers that may otherwise be difficult for investors to access alone ■ Broad diversification by providing exposure to a variety of asset classes, sectors, investment approaches, and managers from a single investment[4]

[3] Qualified purchasers can be individuals or institutions based on one of several criteria, such as ownership of at least $5 million worth of investments.

[4] Diversification does not eliminate the risk of loss.

Today, a number of options exist for investors to access the illiquid private equity sector.

A Closer Look at Opportunistic Multi-Manager Strategies

Opportunistic multi-manager strategies offer diversification as well as other potential benefits such as return enhancement, fee mitigation, and better capital velocity.[5] Two such strategies include co-investments and secondaries.

CO-INVESTMENTS

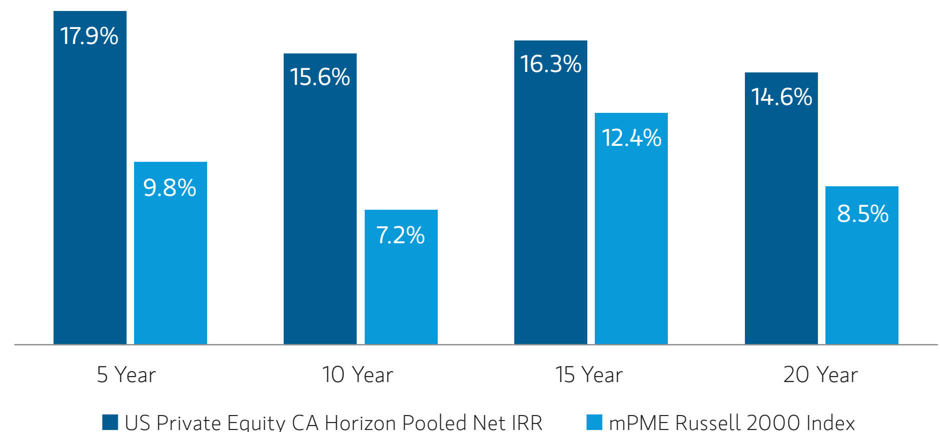
A private equity co-investment is an investment made into a private company or asset alongside a GP who typically serves as the control and active owner of the asset. A co-investment opportunity may arise when a GP seeks to acquire a company for which the required investment capital is greater than what the GP's fund can commit. Funds of funds can often invest in co-investments at a fee level lower than what is charged by a primary fund and sometimes offer exposure to hard-to-access private companies. Since a co-investment is made in a specific company rather than a fund, investors have greater visibility into the investment and often benefit from shorter duration.

SECONDARY TRANSACTIONS

Private equity secondary transactions are investments in which an investor is buying an existing interest or asset from another investor. Secondary transactions allow flexibility for LPs who wish to liquidate or rebalance a portfolio. Buyers of secondaries, meanwhile, may benefit from shorter duration, faster return of capital, potentially discounted access, and enhanced transparency into the underlying portfolio or assets.

DISPLAY 3

U.S. Private Equity Cambridge Associates (CA) Horizon Pooled Returns Versus Public Market Equivalent (Russell 2000)[6,7]



Source: Cambridge Associates (CA) Horizon Pooled Returns and Russell 2000

What Are the Phases of Private Equity Funds?

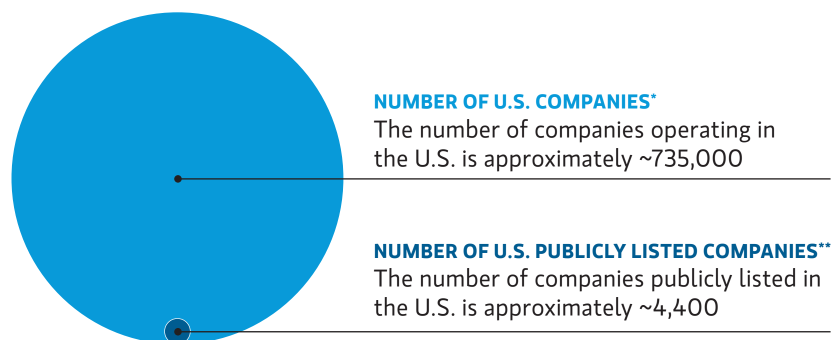
Private equity funds typically have three phases—portfolio construction, value creation, and harvest.

- During the **portfolio construction phase**, the GP identifies attractive investments that fall within scope of its predetermined investment strategy. During this period, the GP will draw capital committed by investors to fund those investments.
- This is followed by the **value creation phase** when the GP focuses on implementing various strategic and operational initiatives to increase the value of portfolio companies. During this time, the value of the unrealized portfolio companies may grow, and it is possible that LPs may

DISPLAY 4

Number Of U.S. Companies Versus U.S. Publicly Listed Companies

As of September 2023



* Source: NAICS Association, as of March 2023. Includes firms with over 20 employees

** Source: World Federation of Exchange – Number of listed domestic companies in Nasdaq and NYSE, as of September 2023

[5] Diversification does not eliminate the risk of loss.

[6] CA Modified Public Market Equivalent (mPME) replicates private investment performance under public market conditions. The Russell 2000 Index is a small-cap U.S. stock market index that makes up the smallest 2,000 stocks in the Russell Index

[7] Past performance is not indicative of future results.

begin to receive distributions as a result of sales of underlying companies that have achieved the GP's intended value creation plan and that have attracted a new buyer.

- Finally, during the **harvest phase**, the GP is focused on positioning the companies for exits via private sales or IPOs. The capital or profits are distributed back to investors once the portfolio companies are realized (i.e. sold) typically on a company-by-company basis.

What Are the Key Factors for Investors to Consider?

Private equity investing offers distinctive qualitative characteristics that differentiate the asset class. These factors include:

- **Illiquidity.** Private equity is generally less liquid than public equity. Private equity funds typically have a contractual initial life of 10 years in the form of a limited partnership, and the funds do not offer fund redemptions or investor liquidity. However, the market rewards investors with greater profit potential to compensate for this relative lack of liquidity.
- **Lower Correlation to Public Markets.** PE can help diversify an investor's portfolio by mitigating public market risk.[8] PE funds offer lower correlation to public market movements because GPs seek to create value by growing revenue, improving earnings, consolidating platforms, and/or repositioning strategies.
- **Higher Potential Return.** Historically, PE has offered compelling, long-term returns to investors relative to public equity returns. *Display 3* demonstrates that over long periods of time, private equity investing has historically provided a material premium over the relevant public benchmark.[9]
- **Deeper Opportunity Set.** Of the over 735,000 companies operating in the United States, 99% of those companies are privately held as shown in *Display 4*. Given the breadth of private companies, the private equity asset class offers investors exposure to opportunities they could not otherwise access via public markets alone. The asset class can offer exposure to much smaller companies than those represented in public markets.
- **Perceived Cost.** Private equity can be an attractive asset class, but there is a cost associated with accessing the illiquid private market. Exposure obtained via commitments to private equity funds includes management fees and carried interest. GPs generally charge a management fee, which covers the normal operational costs of a GP. In addition, GPs receive a share of LP profits, also known as a performance fee or carried interest. The performance fee is generally subject to an appropriate preferred return (i.e., a hurdle rate).[10,11]
- **Greater Alignment of Interest.** There is strong alignment of interest in private equity where the interests of the GPs and the investors are closely matched, which ensures that both are working toward the goal of achieving compelling performance. Alignment is achieved through meaningful GP personal commitments to the funds and through performance fees, where GPs receive a share of profits. The GP's personal financial stake and performance fee structure incentivizes GPs to maximize investor returns, as their compensation is directly tied to the success of the fund.

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[8] Diversification does not eliminate the risk of loss.

[9] Past performance is not indicative of future results.

[10] The level of return that must be achieved by the GP before they are able to claim carried interest.

[11] For discussion purposes only. All terms are subject to a final definitive agreement.

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