NOMURA

Introduction to Private Equity Funds

Nomura Wealth Management Division

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An illustration of the applicable risk rating of the product has been provided to guide the investors on the possible risk rating of the product. The following is a legend for the risk rating. Within each section, the possible ratings which the product may have are shaded in red.

Product Risk Rating

Risk Level	Explanation
1	Very low level of risk with potentially limited returns
2	Low to Medium level of risk with low volatility and expecting below average to average level of returns
3	Medium level of risks with medium level of volatility and expecting average expected returns
4	Medium to high level of risk and volatility and with high variance in the returns
5	High level of risk and volatility with a very high variance in returns

3. Introduction to Private Equity Funds

3.1 Introduction to Private Equity Funds

Broadly defined as investments in public or non-public companies that are privately negotiated transactions and typically result in private ownership of businesses.

Private equity managers are typically independent organizations that often take an active role in the direction of a company seeking to create value, enhance returns and exit successfully.

Spans a spectrum of investment stages and strategies, which principally comprises buyouts (including leveraged buyouts ("LBOs"), which typically acquire control of established businesses with stable cash flows by utilizing debt financing, or venture capital, which invests private capital in start-up to growth stage companies. Alternative means of gaining equity exposure in portfolios.

Some of the common investment strategies and examples
Venture Capital (VC)
Leverage Buyout (LBO)
Private Debt
Real Estate
Small, Mid and Large Cap Buyout
Mezzanine Financing
Infrastructure Strategy
Growth Capital
Special Situation
Fund of Private Equity Funds

(Below are three commonly offered examples.)

VENTURE CAPITAL

Venture capital ("VC") is an important source of financing for start-up companies, 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 often referred to as series A, B, C and so on. Sometimes, VC investments may begin with a "seed" round, which involves initial start-up 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. During the early 1990s, many LBO transactions required only 20-25% in equity to finance their purchases. By contrast, equity contributions to LBOs have exceeded 45% in recent years, 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.

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.

DISTRESSED DEBT

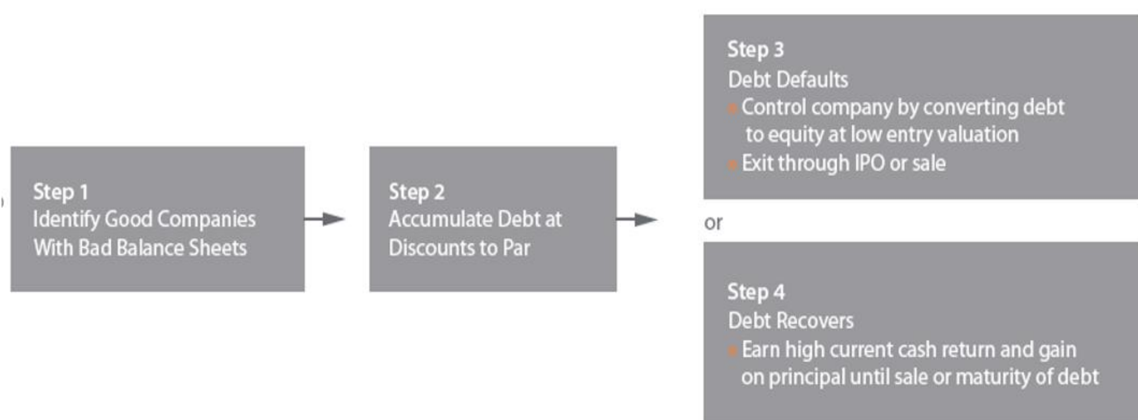
Distressed debt private equity firms typically buy corporate bonds of companies that have either filed for bankruptcy or appear likely to do so in the near future. There are two distinct strategies within distressed debt investing.

The first strategy, as illustrated in Figure 1, 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 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.

Figure 1/ How investors have the potential to profit from distressed debt investing



Source: StepStone analysis.

How a Private Equity Partnership works

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.” 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 honour 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.

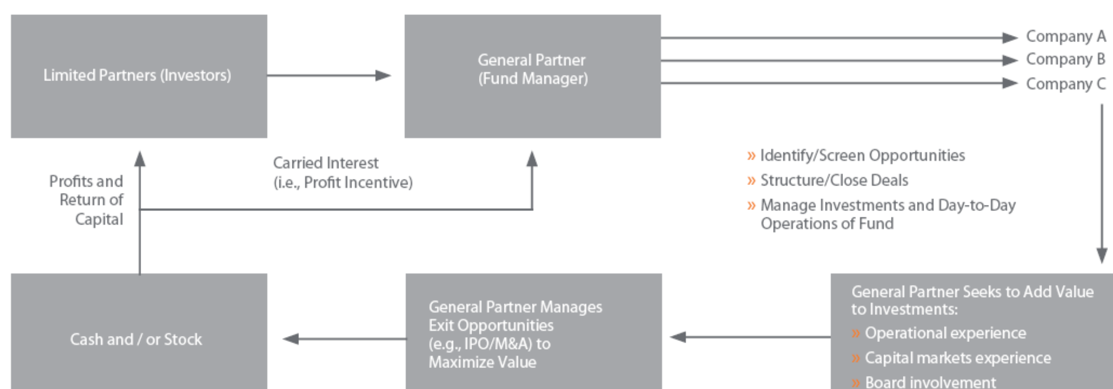
MANAGEMENT FEES AND PROFIT INCENTIVE:

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.



3.2 Benefit of investing in Private Equity

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. Between 2004 and 2014, on average, private equity outperformed the public markets, with a 5.7% premium over the S&P 500.

Over a 20-year period (1993 – 2013), private equity has generated a 7.5% premium over the S&P 500. These performance figures are merely averages, and performance for 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.

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, healthcare 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.

3.3 Investor Profile

- Investor is a Professional Investor as defined under the Securities and Futures Ordinance of Hong Kong or Accredited Investor defined under the Securities and Futures Act of Singapore.

- Investor wants potentially higher returns and is prepared for variable returns which include the risk of losing a substantial part of the money that the investor is investing.

- Investor understands how returns are calculated, is clear about the factors and scenarios that can affect returns and understands a Private Equity fund's investment objective, strategy and approach.

- Investor understands the risks associated with Private Equity funds. Some Private Equity funds use financial derivatives to hedge risks and/or to improve performance. Investor is aware of the risks associated with the use of financial derivatives, including the risk that the provider (or counterparty) of the financial derivatives defaults.

- Investor is prepared to have its money tied up for long periods of time and has adequate financial resources as Private Equity fund is illiquid.

- Investor is familiar with the Private Equity fund manager and Private Equity fund's track record.

3.4 Fees

- All fees will be listed out in the fund prospectus / offering documents.
- The below briefly describes some examples of fee charges which are fund level related.
- Investors should always refer to the offering documents / prospectus of the Private Equity fund for details.

i) Fees and charges payable by you – these represent sales or redemption charges imposed by the distributor of the fund or the fund manager to subscribe or redeem in a fund.

Examples of charges when one subscribes or redeems a fund.

Subscription fee or initial sales charge (also known as “front-end load”)	**Redemption fee** (if redemption available)
Payable when you buy a fund. Ranges from 0% - 3% of your investment	Payable when you sell or redeem the fund. Ranges from 0% - 3% of your investment

ii) Fees and charges by the fund – these are recurring fees that the fund manager, trustee and other parties charge the fund for their services and ultimately reduce your return on investment.

Management fee	**Performance fee / Carried Interest**	**Trustee fee**	**Miscellaneous fees**
An annual fee charged by the fund manager for managing the fund which is paid in regular intervals (quarterly or semi – annual basis) May range from 1% - 2.5% of the committed capital of the fund. After the end of investment period, the management fee is reduced to a percentage of actual invested capital	Typically, a performance fee is charged if the fund achieves returns above its hurdle rate and above the high-water mark. Usually 10% - 20% profits from investments, and referred to as carried interest.	An annual fee charged by the trustee for providing custodian services for safekeeping the fund’s assets Usually 0.1-0.15% per annum of the fund’s NAV	Other fees include fund administration fees, audit fees and legal fees.

- Hurdle Rate: A hurdle rate is the minimum rate of return that the fund must exceed before collecting performance fees.
- High-Water Mark: Highest peak in value that an investment fund/account has achieved.

3.5 Risk consideration

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 is 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 (if available) 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. As such, you should seek all necessary independent advice as you consider desirable and only invest in a private equity fund if you accept the risks involved.

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. As such, you should seek all necessary independent advice as you consider desirable and only invest in a private equity fund if you accept the risks involved.

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.

3.6 Private Equity Glossary

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

» 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”

» 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, normally 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. The carried interest could be different for different funds.

» 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 contractual 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.

» 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.

» Early Stage – A fund investment strategy involving investment in start-up companies 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.

» Financial Buyer – This term typically describes private equity managers or financial institutions that purchase companies or assets.

» 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.

» Hurdle Rate: A hurdle rate is the minimum rate of return that the fund must exceed before collecting performance fees.

» High-Water Mark: Highest peak in value that an investment fund/account has achieved.

» 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-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.

» 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.

» 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).

» 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.

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

» 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.

» Qualified Investor – This term includes an investor who is Professional Investors as defined under the Securities and Futures Ordinance of Hong Kong or Accredited Investor defined under the Securities and Futures Act of Singapore.

» 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.

» 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.

» 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.

» Waterfall - Private equity waterfalls are a method of dividing capital gains or investment returns between all participants. The parties who benefit from equity waterfalls are typically limited partners (LPs), who are the investors, and the general partner (GP) or sponsor, who can be property managers, real estate firms, or corporations. The term “waterfall” defines how the profits from an investment make their way down to everyone involved in the venture.
The two most common forms of distribution waterfalls are the American Waterfall and the European Waterfall.

In the European Waterfall model, investors receive preference, which is also called the global waterfall. It’s typically applied directly at the aggregate fund level. Managers don’t receive any profits until investors make back their initial investment and the amount owed in the preferred return. It can take GPs a long time, up to several years, before they make good on their initial investment and start seeing further profits.

In the American Waterfall model, it’s the GPs who benefit more. The model gets applied to every deal instead of at the fund level. The risk gets spread out over each investment and ensures that sponsors receive their investment before LPs receive back their initial investment along with preferred returns.

» 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.

Source: StepStone