Private Markets Discussion

Todd Jankowski, CIPM, CFA

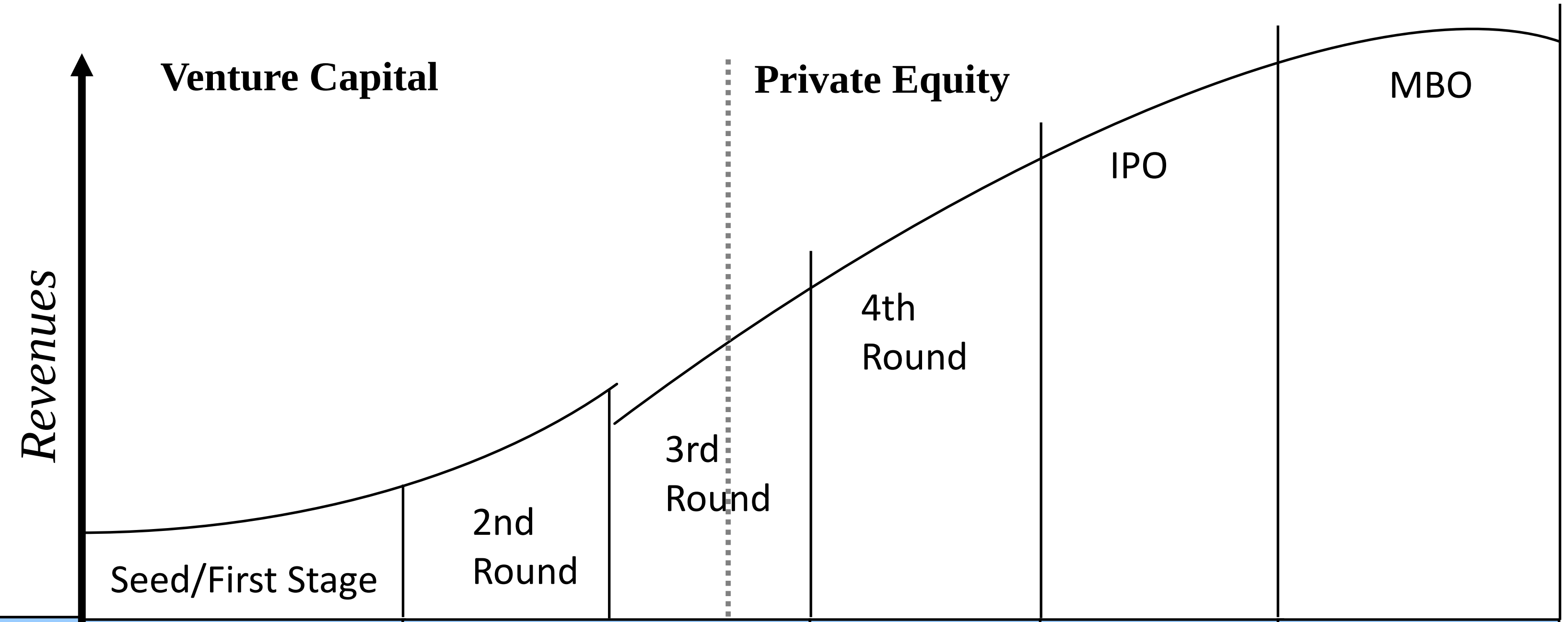
November 2022

Topics

- Private Markets
- Subscription Lines of Credit (Bridge Loans)
- Private Market Equivalents (PME)
- GIPS Asset Owners vs Firms

Private Equity

Long term equity investments in non-publicly traded companies



Stage	*Start-Up*	*Expansion*	*Pre-IPO*	*Public*	*Buyout*
Principal Risks	Product Development	Market Development	Managing Growth	Market	Price & Debt Service
SECONDARIES					

Performance Track Records-(Not so-) Recent SEC Focus

- Impact to internal rate of return (IRR) from use of sub-line loans in lieu of initial capital calls
- Impact to IRR and multiples from use recallable capital
- Calculating net IRR returns inclusive of GP and LP capital
- Presenting “NM” instead of negative returns early in investment period
- Changes to assumptions for projected IRR’s relative to actual IRR’s
- Performance from a prior firm

Source: The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers, National Exam Program Risk Alert, September 14, 2017

The contentious art of reporting two IRRs

When an IRR has been inflated by subscription lines of credit, does the fund manager need to present a second figure to investors?

Philippa Kent - 27 January 2020 Investor Reporting

MJ HUDSON

ARTICLE Share Follow Question Print Trai

UK: Line Dance: The Rise Of Subscription Credit Lines In Privat Funds

20 March 2019

Institutional Investor

PORTFOLIO

Private Equity Returns Are Being 'Distorted' by Loans, Research Finds

A pair of Carnegie Mellon business school professors have waded into the subscription credit line debate.

By Amy Whyte July 03, 2019

Institutions Know They're Being Hoodwinked by Private Equity

And they're pushing back.

By Julie Segal January 13, 2020

Institutional Investor

Search Subscribe Sign In

Portfolio Corner Office Culture Premium Research Video Inr

PORTFOLIO

The Faulty Metric at the Center of Private Equity's Value Proposition

Harvard Business Review

Entrepreneurial Financing | The Truth About Private Equity Perform

Entrepreneurial Financing

The Truth About Private Equity Performance

by Oliver F. Gottschalg and Ludovic Phalippou

From the Magazine (December 2007)

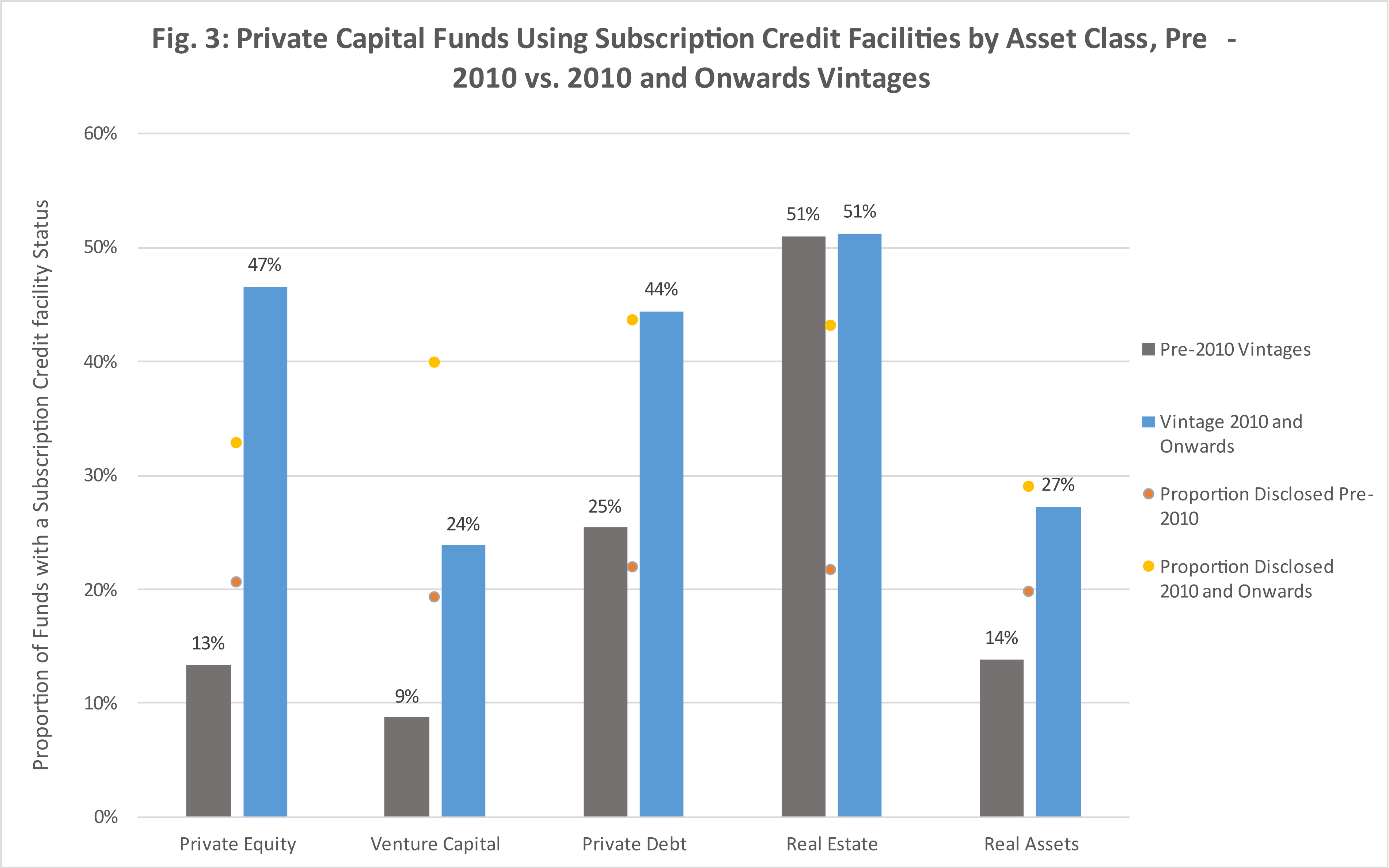
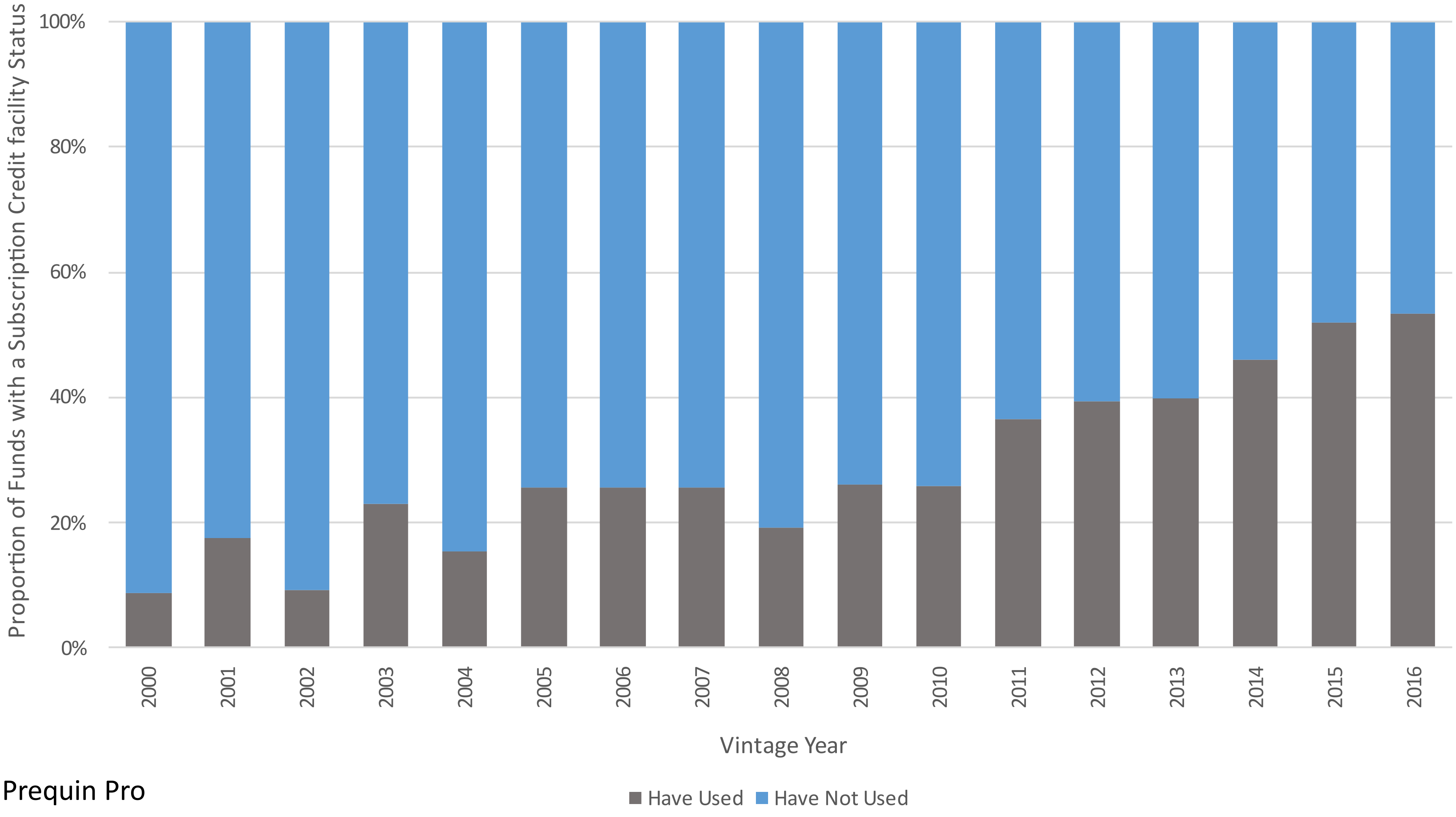


Fig. 3: Private Capital Funds Using Subscription Credit Facilities by Asset Class, Pre - 2010 vs. 2010 and Onwards Vintages
Proportion of Funds with a Subscription Credit facility Status
60%
50%
40%
30%
20%
10%
0%
13%
47%
9%
24%
25%
44%
51%
51%
14%
27%
Private Equity
Venture Capital
Private Debt
Real Estate
Real Assets
Pre-2010 Vintages
Vintage 2010 and Onwards
Proportion Disclosed Pre-2010
Proportion Disclosed 2010 and Onwards

Fig. 2: Private Capital Funds Using Subscription Credit Facilities, Vintage 2000 - 2016



Prequin Pro

Subscription Lines of Credit

- Subscription lines are **bank loans extended to fund** that permit GPs **to use borrowings, rather than drawn LP capital**, for investments or fees (or yes distributions) **during the investment period**.
- Sub lines facilities **do not change the total amount of LP capital drawn.** However, they do **change the time of the LP capital drawn,** shifting towards the end of the fund's life.

Subscription Lines of Credit

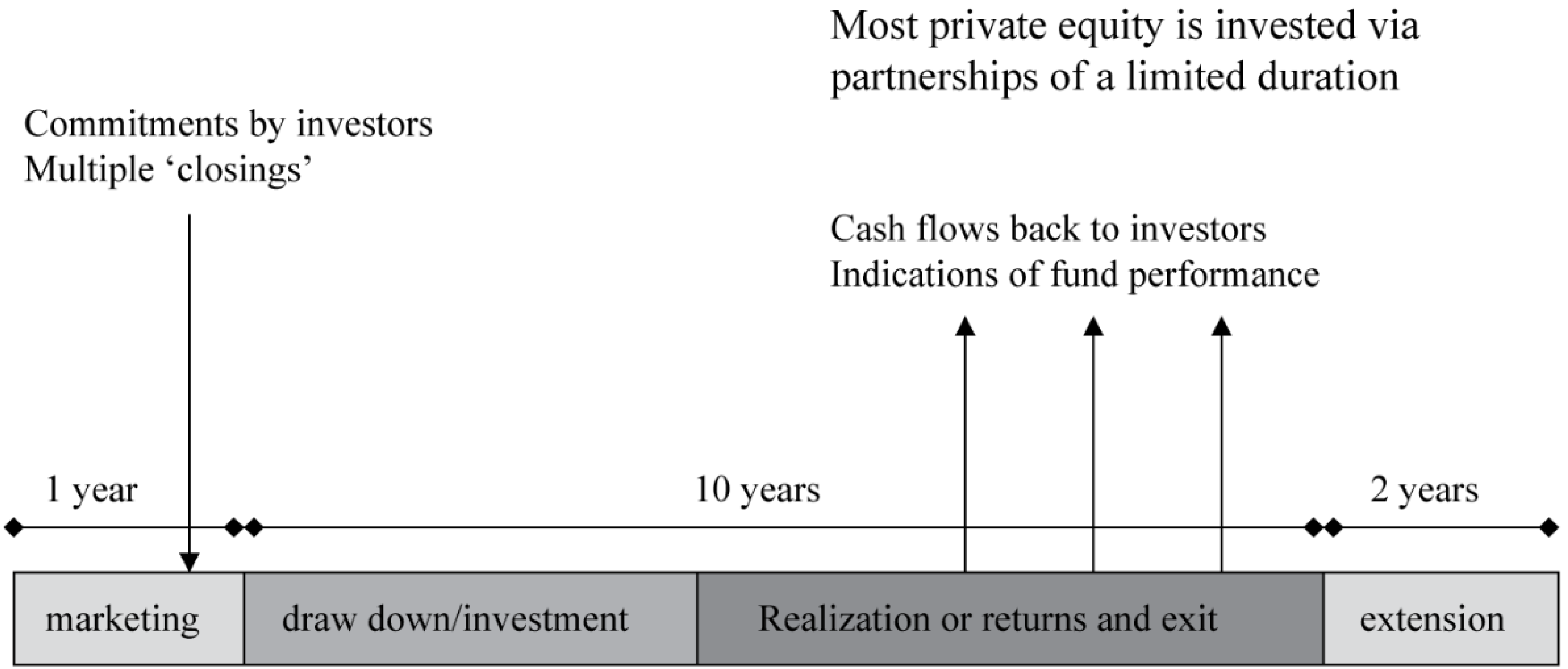
- Originally: Lines of credit were initially used to bridge capital calls for 30 days or fewer.
  - Operational efficiency through reduced calls
  - Min cash on hand to reduce negative impact on IRR
  - Min cost due to size and short borrowing period
  - Limited usage due to LP-Agreement (LPA) restrictions

- More recent: Amounts and length of borrowing have increased due to low interest rate environment
  - LPA restrictions reduced with comfort
  - Banks willing to lend for longer periods
  - Delaying early capital calls can create positive IRR impact and reduce total drawn from client

Subscription Lines of Credit Used For

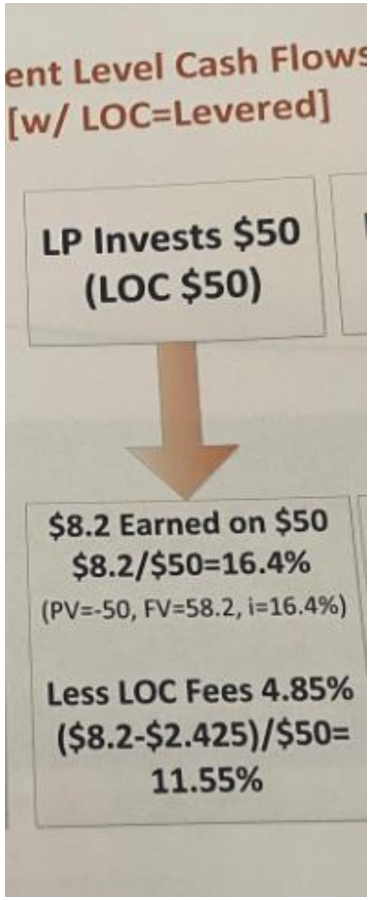
- Enhanced cash management—shift cap calls later in the funds life to improve IRR and reduce the max amount drawn
- Capital call bridge—improve operational efficiency by reducing the number of capital calls and min cash on hand.
- Liquidity bridge—provide working capital for funds without additional undrawn capital or for fund which do not have enough cash on hand and are unable to call from LPs in time

External Cash Flows (calls / distributions)

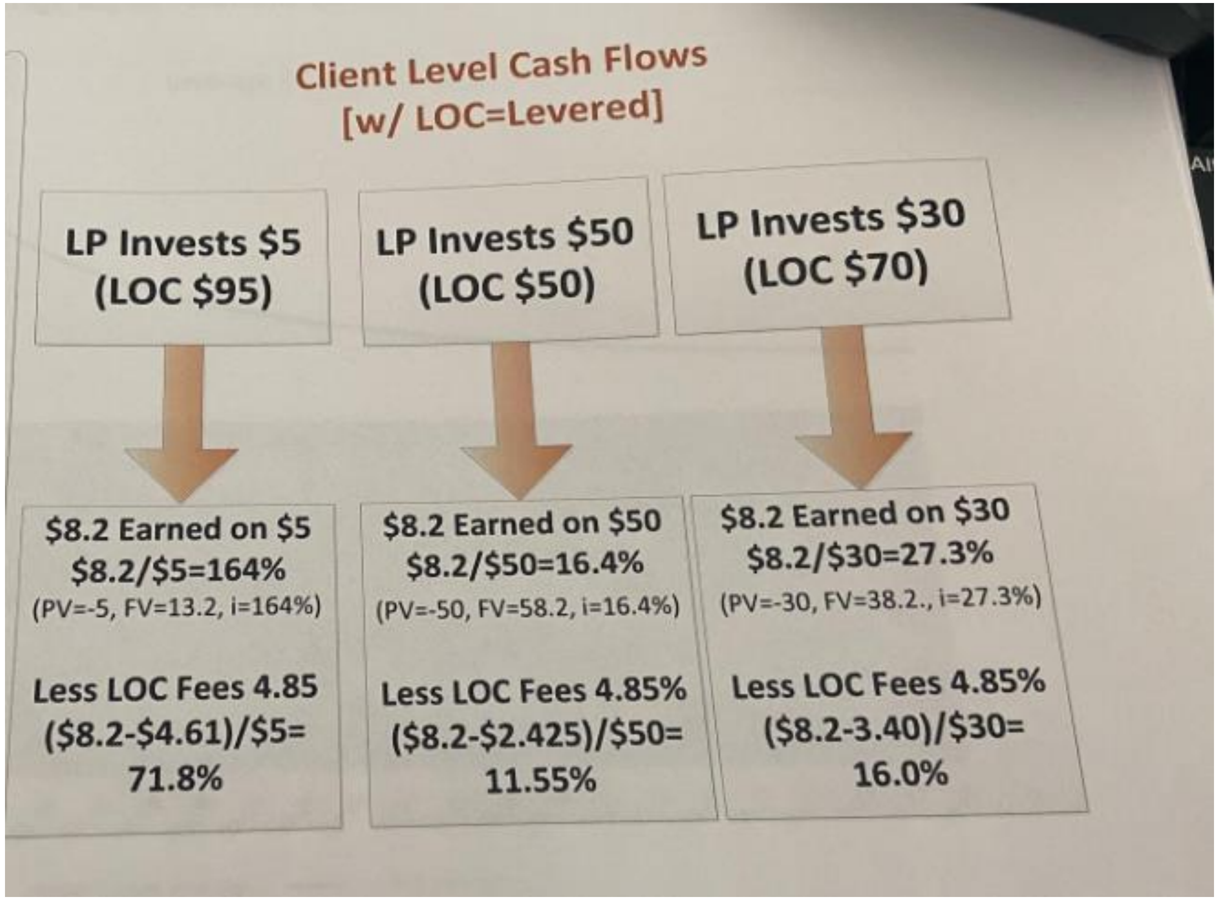


Subscription Line Example

Subscription Line Example $50 Called and $50 LOC



Subscription Line Example



Benchmark Private Market Equivalent (PME)

- Measures the opportunity cost of investing in a private market investment instead of a public market.

PME	Pros	Cons
Index Comparison Method (ICM) aka Long Nickels	Simple and intuitive	No solution in some cases due to significant outperformance
PME+	Robust; provides solution even for periods of drastic outperformance	Mathematically does not represent the true IRR; not realistic to scale cash flows based on subsequent cash flows
Kaplan & Schoar (K&S)	Robust; directionally accurate	Not an IRR. >1 or < 1
K&S Implied	Robust, takes the form of a return rather than a ratio	Still an estimate and not an IRR. Loses accuracy as cash flows become less evenly dispersed. Sensitive to the duration assumption
Direct Alpha	Robust	New and not yet widely used. Less intuitive than other methods.

Would you rather have an annualized 16% IRR or 10% IRR?

Would you rather have an annualized 16% IRR OR 10% IRR?

What if 16% IRR with TVPI = 3.2x OR 10% IRR with TVPI = 3.2x?

What if 16% IRR with TVPI = 3.2x OR 16% IRR with TVPI = 1.2x?

Zero-Coupon Equivalent Duration

Additional information helpful in interpreting IRR

Zero-Coupon Equivalent Return (ZCER)

$$ZCER = \sqrt[1/n]{TVPI} - 1$$

Zero-Coupon Equivalent Duration (ZCED)

$$ZCED = \frac{\ln(TVPI)}{\ln(1 + IRR)}$$

ZCED can be interpreted as the dollar-weighted time-weighted average holding period.

Zero-Coupon Equivalent Duration

Additional information helpful in interpreting IRR

Zero-Coupon Equivalent Return (ZCER)

$$ZCER = \sqrt[1/n]{TVPI} - 1$$

Zero-Coupon Equivalent Duration (ZCED)

$$ZCED = \frac{\ln(TVPI)}{\ln(1 + IRR)}$$

ZCED can be interpreted as the dollar-weighted time-weighted average holding period.

What if 16% IRR with TVPI = 3.2x OR 10% IRR with TVPI = 3.2x?

ln(3.2)/ln(1.16)= 7.84 ln(3.2)/ln(1.10)= 12.2

What if 16% IRR with TVPI = 3.2x OR 16% IRR with TVPI = 1.2x?

ln(3.2)/ln(1.16)= 7.84 ln(1.2)/ln(1.16)= 1.22

GIPS Asset Owner Reports

Asset owners are required to present time-weighted returns for total funds and must prepare GIPS Asset Owner Reports.

Asset owners may also include money-weighted returns in GIPS Asset Owner Reports for total funds but are not required to do so. Asset owners that choose to create and report additional composites in compliance with the GIPS standards may choose to present either time-weighted returns or money-weighted returns. Each reporting section is self-contained and includes all requirements and recommendations relevant to that particular report.

GIPS Asset Owners Provision 25.A.3 Additional Composite

For composites where the underlying portfolios have committed capital, the asset owner **must** present the following items as of the most recent annual period end:

a. Composite since-inception paid-in capital.
b. Composite since-inception distributions.
c. Composite cumulative committed capital.
d. Total value to since-inception paid-in capital (investment multiple or tvpi).
e. Since-inception distributions to since-inception paid-in capital (realization multiple or dpi).
f. Since-inception paid-in capital to cumulative committed capital (pic multiple).
g. Residual value to since-inception paid-in capital (unrealized multiple or rvpi).

Firms GIPS Provision (Not Asset Owners)

1.A.35 The firm must present time-weighted returns unless certain criteria are met, in which case the firm may present money-weighted returns. The firm may present money-weighted returns only if the firm has control over the external cash flows into the portfolios in the composite or pooled fund, and the portfolios in the composite have or the pooled fund has at least one of the following characteristics:

a. Closed-end
b. Fixed life
c. Fixed commitment
d. Illiquid investments as a significant part of the investment strategy.

5.A.2 If a subscription line of credit is used, the firm must present the composite since-inception money-weighted return both with and without the subscription line of credit through the most recent annual period end. The firm is not required to present returns without the subscription line of credit when the subscription line of credit has all of the following characteristics:

a. The principal was repaid within 120 days using committed capital drawn down through a capital call.
b. No principal was used to fund distributions.

Discussion?